

FEDERAL RESERVE ACCOUNTABILITY AND REFORM

HEARING

BEFORE THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE ACCOUNTABILITY OF THE FEDERAL RESERVE SYSTEM
TO CONGRESS AND THE AMERICAN PUBLIC

MARCH 3, 2015

Printed for the use of the Committee on Banking, Housing, and Urban Affairs



Available at: <http://www.fdsys.gov/>

U.S. GOVERNMENT PUBLISHING OFFICE

93-893 PDF

WASHINGTON : 2015

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

RICHARD C. SHELBY, Alabama, *Chairman*

MICHAEL CRAPO, Idaho	SHERROD BROWN, Ohio
BOB CORKER, Tennessee	JACK REED, Rhode Island
DAVID VITTER, Louisiana	CHARLES E. SCHUMER, New York
PATRICK J. TOOMEY, Pennsylvania	ROBERT MENENDEZ, New Jersey
MARK KIRK, Illinois	JON TESTER, Montana
DEAN HELLER, Nevada	MARK R. WARNER, Virginia
TIM SCOTT, South Carolina	JEFF MERKLEY, Oregon
BEN SASSE, Nebraska	ELIZABETH WARREN, Massachusetts
TOM COTTON, Arkansas	HEIDI HEITKAMP, North Dakota
MIKE ROUNDS, South Dakota	JOE DONNELLY, Indiana
JERRY MORAN, Kansas	

WILLIAM D. DUHNKE III, *Staff Director and Counsel*

MARK POWDEN, *Democratic Staff Director*

JELENA MCWILLIAMS, *Chief Counsel*

DANA WADE, *Deputy Staff Director*

JACK DUNN III, *Professional Staff Member*

LAURA SWANSON, *Democratic Deputy Staff Director*

GRAHAM STEELE, *Democratic Chief Counsel*

PHIL RUDD, *Democratic Legislative Assistant*

DAWN RATLIFF, *Chief Clerk*

TROY CORNELL, *Hearing Clerk*

SHELVIN SIMMONS, *IT Director*

JIM CROWELL, *Editor*

C O N T E N T S

TUESDAY, MARCH 3, 2015

	Page
Opening statement of Chairman Shelby	1
Opening statements, comments, or prepared statements of:	
Senator Brown	2

WITNESSES

John B. Taylor, Mary and Robert Raymond Professor of Economics, Stanford University	4
Prepared statement	34
Allan H. Meltzer, The Allan H. Meltzer University Professor of Political Economy, Tepper School of Business, Carnegie Mellon University	6
Prepared statement	36
Responses to written questions of:	
Chairman Shelby	72
Senator Vitter	74
Paul H. Kupiec, Resident Scholar, American Enterprise Institute	7
Prepared statement	58
Responses to written questions of:	
Chairman Shelby	75
Senator Vitter	79
Senator Heller	80
Peter Conti-Brown, Academic Fellow, Stanford Law School, Rock Center for Corporate Governance	8
Prepared statement	66
Chairman Shelby	83
Senator Vitter	86

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Chart of the Federal Reserve Survey of Consumer Finances submitted by Senator Brown	88
Testimony of Ron Paul, Chairman, Campaign for Liberty	89

FEDERAL RESERVE ACCOUNTABILITY AND REFORM

TUESDAY, MARCH 3, 2015

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:35 p.m., in room SD-538, Dirksen Senate Office Building, Hon. Richard C. Shelby, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order. We have had a vote. That is the reason we are not exactly on time, so we will get started.

Last week, the Committee began examining potential reforms to the Federal Reserve System. We heard the views of Federal Reserve Chair Janet Yellen on this topic right here. Today we will further explore options to improve the oversight and structure of the Fed.

Many of the Fed's actions since the financial crisis have emphasized the need for greater accountability. The Fed has undertaken three rounds of quantitative easing and grown its balance sheet to a staggering \$4.5 trillion.

Although the Fed has concluded new bond purchases, it has not yet begun to unwind its balance sheet. It has also kept its target interest rate close to 0 percent for more than 6 years.

After these unprecedented actions, how will the Fed measure its impact on the economy? It is not entirely clear. Considering the extent of the monetary stimulus and the risk involved, the Fed should be prepared to explain this. And what indicators will the Fed use to determine the appropriate time to unwind its balance sheet? Again, it is not clear. The Fed should not only be able to answer these questions; it should be held accountable for its actions.

Federal Reserve officials have stressed the importance of the Fed's independence, but such independence does not mean that it is immune from congressional oversight. After all, Congress wrote the statute that created the Fed and sets forth its policy objectives.

Last week, Chair Yellen testified before this Committee that she believes the current structure of the Federal Reserve System is working well. The current structure, however, has allowed the Fed to expand its reach in many ways.

The Fed's jurisdiction now covers almost every aspect of the financial system. Much of the expansion in its authority has been centralized in Washington, DC, and New York. The Fed now has

extensive new rulemaking power which gives it the ability to regulate entities it did not before the crisis. Dodd-Frank greatly expanded the regulatory reach of the Federal Reserve. It did not, however, examine whether it was correctly structured to account for these new and expansive powers.

Therefore, the Committee will be examining the appropriateness of the Fed's current structure in a post- Dodd-Frank world. As part of this effort, we will review proposals aimed at providing greater clarity in Fed decision making and reforming the composition of the Federal Reserve System. I have asked for the input of the Federal Reserve Banks and welcome their feedback in the coming weeks.

Today I look forward to hearing from the witnesses on proposals to reform or to restructure the Fed. We have a very distinguished panel of experts before us, and I thank them for being here today.

The U.S. Congress created the Federal Reserve System to perform a specific set of functions. And while the Fed is an important institution, it is not beyond the reach of congressional oversight. I believe it is entirely appropriate that Congress periodically review the Fed's structure and its authorities. If we believe changes are necessary, changes should be made. But first we should examine all of this.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. Thank you for doing this hearing today.

I would like to, first of all, welcome Mr. Kupiec and Mr. Meltzer back. They both testified at a Subcommittee hearing that Senator Toomey and I did a couple of years ago. Welcome back.

The Federal Reserve System was designed, as we know, to be accountable to Congress and to the American people, while maintaining the central bank's independence, all important functions. The Chair of the Fed is appointed by the President and confirmed, as are the other six Governors, and the Chair is required to testify before Congress twice a year, as she did last week to this Committee.

Over time, the Fed has become more accountable to the public. The Fed's operations are the most transparent they have ever been in its history. Various Government agencies and an outside auditing firm regularly review and audit the Fed's activities and financial statements, with important exceptions. After the crisis, as we know, the Fed began to issue regular reports to Congress on its lending programs. In December 2010, the Fed released loan details for each emergency program created during the crisis. It publicly releases records on its discount window loans and open market operations with a 2-year lag.

As a result of Wall Street reform, the GAO audited the Fed's emergency facilities and governance. The Fed Open Market Committee holds press conferences four times a year—half of its meetings, if you will—to present its current economic projections and provide context for its monetary policy decisions. I continue to have concerns about the slow pace of the recovery for most Americans. FOMC's monetary policy, I would argue, has allowed—factually has allowed for sustained economic growth.

Some pundits and politicians have been critical of these steps, predicting runaway inflation for years. They have been decidedly wrong. But our economy continues to gain jobs, and prices have remained stable.

Under the guise of additional transparency and accountability, some are proposing to second-guess the decisions of an independent central bank. The Fed certainly looms larger in the economy than it has in the past, but the Fed's extraordinary measures were the result of extraordinary excesses in our economy. And changing course to pursue only one part of the Fed's mandate harms workers.

As a result of the crisis, the Fed gained new authority over the Nation's largest banks in nonbank firms designated as "systemically important." If we learned anything from the financial crisis, it is that we all have a responsibility to remain vigilant in our oversight of Wall Street risk taking.

Governor Tarullo has called for capping on the nondeposit liabilities of the largest financial institutions as a way to end too big to fail, a proposal similar to the one that introduced in 2010 that Dr. Meltzer commented on and that I offered as an amendment to the Dodd-Frank Act that both Democrats and Republicans, including some on this Committee, supported.

We should hold a hearing on that proposal, Mr. Chair. We should give the Federal Reserve the authority to implement that. And rather than attempting to interfere in or, more problematically, dictate monetary policy, Congress should focus on whether the Fed is protecting consumers, as is its charge; ensuring safety and soundness, perhaps its most important function; and strengthening the financial stability of our financial system.

The Committee should consider if the current governance of the Fed appropriately holds the regulators accountable and encourages diverse perspectives. For example, the Reserve Bank Presidents are not Presidentially appointed. We know the seven Washington Governors are. We know the Presidents of the 12 districts are not. The Class A and Class B Directors of each of the Federal Reserve Bank Boards are either member banks or chosen by the member banks. The Class C Directors are selected somehow, some way, but not all that specifically prescribed, by the Board of Governors in Washington, the Class C Directors in the 12 district.

With independent and accountable leaders, diverse perspectives, and strong regulation, the Federal Reserve System can be responsive, should be more responsive to the American public. That is where we should focus our discussion of reforms. Some changes would require legislation, some would not. We should be thoughtful, we should be careful before we choose to proceed.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

I would like to introduce our distinguished panel to the Committee. Their written testimony, all of it, will be made part of the record in its entirety.

First we will hear the testimony of Dr. John B. Taylor, who is no stranger to this Committee. Dr. Taylor is the Mary and Robert Raymond Professor of Economics at Stanford University. He is a

well-known expert on monetary policy, and I welcome him again here today.

Second we will hear from Dr. Allan Meltzer, who is the Allan H. Meltzer University Professor of Political Economy at the Tepper School of Business at Carnegie Mellon University. Dr. Meltzer wrote the definitive history of the Fed and is well regarded for his knowledge on this subject. We welcome you again to the Committee.

Next we will hear testimony from Dr. Paul Kupiec, a Resident Scholar at the American Enterprise Institute, who has held positions at the FDIC and the Federal Reserve Board, among others.

Finally, we will hear from Mr. Peter Conti-Brown, an Academic Fellow at Stanford Law School, Rock Center for Corporate Governance, who has also written on these matters.

I thank all of you for appearing here today. Dr. Taylor, we will start with you. You need to turn on the mic.

STATEMENT OF JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you, Mr. Chairman, Ranking Member Brown, and other Members of the Committee, for inviting me to testify. I would like to focus on a particular reform that I think would improve the accountability and transparency of monetary policy and lead to better economic performance. The reform would simply require the Fed to describe its strategy for monetary policy. It is a reform about which you, Mr. Chairman, and Congressman Jeb Hensarling asked Fed Chair Janet Yellen quite a bit about at her hearings last week.

The prime example of such a reform is a bill which passed the House Financial Services Committee last year. The bill would require that the Fed, and I quote, “describe the strategy or rule of the Federal Open Market Committee for the systematic quantitative adjustment” of its policy instruments. It would be the Fed’s job to choose the strategy and to describe it. The Fed could change the strategy or deviate from it if circumstances called for it, but the Fed would have to explain why.

In considering the merits of such a reform, I think it is important to emphasize the word “strategy” in the bill. Though economists frequently use the word “rule” rather than “strategy,” the term “rule” can sometimes be intimidating if one imagines, incorrectly, that a rules-based strategy must be purely mechanical.

The Congress, through the Banking Committee and the Financial Services Committee, is in a good position—in fact, it is a unique position in our Government—to oversee monetary policy in a strategic sense, not in a tactical sense.

Experienced policymakers know the importance of having a strategy and the close connection between a strategy and rules-based processes. George Shultz put it this way, and I quote: “I think it is important, based on my own experience, to have a rules-based monetary policy. If you have policy rule, you have a strategy. A strategy is a key element in getting somewhere.”

Fed Chair Janet Yellen made similar observations when she served on the Federal Reserve Board in the 1990s. She explained, and I will quote, “The existence of policy tradeoffs requires a strat-

egy for managing them.” And then she went on to describe a policy rule pointing out “several desirable features” it has “as a general strategy for conducting monetary policy.” She also stated a rule would “help the Federal Reserve communicate to the public the rationale behind policy moves, and how those moves are consistent with its objectives.”

Experience and research by many people over many years has shown that a rules-based monetary strategy leads to good economic performance. During periods when policy is more rules-based, as in much of the 1980s and the 1990s, the economy performed well. During periods such as the 1970s and the past decade when policy has been more discretionary, economic performance has been poor.

But as economists Michael Belongia and Peter Ireland put it recently, “For all the talk about ‘transparency,’ . . . the process—or rule—by which the FOMC intends to defend its 2-percent inflation target remains unknown.”

In answering questions last week, the Fed Chair said, and I quote, “I do not believe that the Fed should chain itself to any mechanical rule.” But the reforms in question would not chain the Fed. The Fed would choose its own strategy, which presumably would not be mechanical. And it could change or deviation from the strategy if it gave the reasons why.

Another concern is that by publicly describing its strategy, the Fed would lose independence. But based on my own experience in Government, the opposite is more likely. A clear public strategy helps prevent policymakers from bending to pressure.

Some have expressed concern that a rules-based strategy would be too rigid. But this reform provides flexibility. It would allow the Fed to serve as lender of last resort and take appropriate actions in the event of a crisis.

Another concern is expressed by those who claim the reform would require the Fed to follow the so-called Taylor rule, but that is not the case. The bill from the House does require the Fed to describe how its strategy or rule might differ from a “reference rule,” which happens to be the Taylor rule. However, that is a natural and routine task for people who work on rules, and the Fed does it all the time.

There is precedent for this type of congressional oversight. I think it is important to emphasize that, in this Committee in particular. Previous legislation, which was put in the Federal Reserve Act in 1977 and removed in the year 2000, required the Fed to report on the ranges of its money and credit aggregates. In many ways, the reform I am referring to today is simply needed to fill the void left by the removal of that requirement in the year 2000.

The Congress and this Committee in particular have an opportunity to move forward on such a reform, I believe in a nonpartisan way, with constructive input from the Fed. The result would be a more effective monetary policy based on an accountable strategy.

Thank you. I am happy to answer any questions.

Chairman SHELBY. Dr. Meltzer.

**STATEMENT OF ALLAN H. MELTZER, THE ALLAN H. MELTZER
UNIVERSITY PROFESSOR OF POLITICAL ECONOMY, TEPPER
SCHOOL OF BUSINESS, CARNEGIE MELLON UNIVERSITY**

Mr. MELTZER. Mr. Chairman, Senator Brown, other Members, I welcome the opportunity to discuss this issue with you.

Let me step back and ask, What do you think James Madison, the founder, the writer, the author of our Constitution, would say if he were told that an agency of the Federal Government has increased its balance sheet by a factor of four, four times what it had before, without any substantial oversight on the part of this Committee or the House Committee? I think he would be appalled. And I am appalled, and you should be appalled. That is a sign that we need change. We need change to improve the oversight that this Committee and the House Committee exercises over the Fed. You have the responsibility. Article I, Section 8 gives that to you.

But you do not have the ability to exercise authority. You are busy people. You are involved in many issues. The Chairperson of the Fed is a person who has devoted his life to monetary policy. There is not any series of questions that you can ask on the fly that they are not going to be able to brush aside. That is why you need a rule. I agree with John Taylor about some of the reasons for the rule, but I believe one of the most important is that Congress has to fulfill its obligation to monitor the Fed, and it cannot do that now because the Chairman of the Fed can come in here, as Alan Greenspan has said on occasion, Paul Volcker has said on occasion, and they can tell you whatever it is they wish, and it is very hard for you to contradict them.

So you need a rule which says, look, you said you were going to do this, and you have not done it. That requires an answer, and that I think is one of the most important reasons why we need some kind of a rule.

Now, the idea of a rule is not some newfangled idea. The Federal Reserve in 1913 started under two substantial rules. Rules. One was the gold standard. The other was a rule which, listen, you are not allowed to buy any Government bonds for any purpose. That rule was relaxed, and then it was circumvented, because while they cannot lend money directly to the Treasury, they can buy it in the market, buy the Treasury's debt in the market the moment after it comes out. So those rules were, by the 1920s and the 1930s, completely circumvented. The gold standard had gone. The other rule, which bound the Fed to be responsible and not to finance the Treasury's debt the way it has been doing, those rules were gone.

So there is a need for improved oversight, and there is a need for Congress to impose a burden on the Fed.

Is the Fed now an independent agency? In part, but only in part. The New York Bank is the agent primarily these days of the New York banks. The Fed Board from the very beginning, back in Woodrow Wilson's time, was always referred to as "the political branch of the Fed," the regional banks being the academic or reliable public policy agencies. And as crises have occurred, the power of the Board has increased, and the power of the banks has been reduced. So the Fed is a more political institution than it has been in the past.

Senator Brown and Senator Vitter introduced a bipartisan bill dealing with the question of oversight of financial fragility. The essence of that bill is a simple but most important point. It asks you to think about this question: Who is going to be a better watchdog of responsible, prudent policies—the equity owners of a bank or the regulators? Well, we know the answer. The regulators totally failed in 2006 and 2007 to do things. They allowed agencies, banks, to set up off-balance-sheet facilities that bought these bad mortgages, had no capital in them. They did not regulate at all in advance of the crisis. In fact, they denied that there was such a thing as a need for regulation in advance of the crisis.

The Brown-Vitter bill says the responsibility will be exercised most effectively if you put the capital requirement high enough so that if the management is lax, the principal stockholders will say, “What in God’s name are you doing to our money?” That is what you want.

Chairman SHELBY. Dr. Kupiec.

**STATEMENT OF PAUL H. KUPIEC, RESIDENT SCHOLAR,
AMERICAN ENTERPRISE INSTITUTE**

Mr. KUPIEC. Chairman Shelby, Ranking Member Brown, and distinguished Members of the Committee, thank you for convening today’s hearing. I have submitted detailed written testimony which I will summarize in my oral remarks.

Congress retains the responsibility for Federal Reserve oversight, and it may exercise this oversight in many ways—through laws requiring transparency and public disclosure, through regular reports to Congress, or through special hearings like today’s.

Congress may also use the Government Accountability Office, or GAO, to investigate or audit Fed performance. GAO audits are a flexible tool. They produce useful reports overall, but these reports can sometimes be superficial and detect only obvious weaknesses in Government agency practices and performance. For monetary policy oversight, legislation will be required because existing laws prohibit the GAO from evaluating the Federal Reserve’s activities on monetary policy.

The GAO, however, may examine other Federal Reserve activities, including the Fed’s expanded regulatory powers under the Dodd-Frank Act. In my opinion, many Federal Reserve Board regulatory activities merit closer congressional oversight. Because time is limited, I will focus on three areas that are especially important.

First, Congress should examine the Fed’s involvement with international standard-setting bodies, like the Financial Stability Board, or FSB. The Fed has enormous influence over FSB policy development because the Fed contributes a very large and highly credentialed staff to these FSB activities. FSB working groups formulate the FSB’s financial stability policies, its G-SIFI designations, and its international agreements on heightened supervision and capital regulation.

The FSB’s goal is to promote and impose uniform international financial stability policies on its members, and its members include the Federal Reserve Board. It is not a coincidence that the FSB regulatory policies are subsequently introduced as U.S. regulatory policy. But the Federal Reserve does not consult the Congress be-

fore negotiating or reaching agreement on FSB policy directives, even though these directives look a lot like international treaties.

This worrisome pattern has appeared in FSOC designation decisions on insurance companies. The FSB published a list of insurance G-SIFIs, and only later were these G-SIFIs designated by the FSOC, despite protests from multiple U.S. insurance regulators on the designation. There are danger signs that this pattern will be repeated. On shadow banking, the FSB is in the process of making G-SIFI designations and formulating heightened supervision and capital regulations. For insurance, FSB work is underway on capital requirements and heightened regulations.

My second suggestion is that Congress critically examine the recurring Board of Governors' stress tests mandated by Section 165 of the Dodd-Frank Act. These stress tests are very expensive for both banks and bank regulators. Yet there is no evidence that these tests are a cost-effective method for supervising individual financial institutions or for even identifying hidden risks in the financial sector. The quantitative test outcomes are arbitrary and completely under the control of the Federal Reserve Board because they are driven by the Fed's subjective modeling judgments. The uncertainty associated with these tests make it difficult for banks to anticipate their capital needs when they consider future business plans.

My final recommendation is for Congress to investigate the conflict that has been created by the Fed's expanded insurance powers under Dodd-Frank. Using new powers, the Fed is now examining insurers that have long been examined by State insurance supervisors. The old system has worked perfectly well.

About one-third of the insurance industry is now facing Fed supervision. For this industry segment, the Fed is also imposing bank holding company capital standards on top of the capital standards set by State insurance regulators. This Fed entry into domestic insurance supervision and the Fed's participation in the FSB insurance work streams developing international capital standards for insurance companies has created concerns that the Fed will seek to impose bank-style capital regulation on all U.S. insurance companies. Dodd-Frank framers were careful not to create a national insurance regulator, and yet the Fed is taking steps that could in the near future make it de facto the national insurance regulator.

Thank you.

Chairman SHELBY. Mr. Conti-Brown.

**STATEMENT OF PETER CONTI-BROWN, ACADEMIC FELLOW,
STANFORD LAW SCHOOL, ROCK CENTER FOR CORPORATE
GOVERNANCE**

Mr. CONTI-BROWN. Chairman Shelby, Ranking Member Brown, distinguished Members of the Committee, thank you for the opportunity you have given me to testify today. I am a legal scholar and a financial historian who focuses on the institutional evolution of the Federal Reserve System. Much of my written testimony and oral testimony I will be presenting today come from my book, "The Power and Independence of the Federal Reserve," which is forthcoming from Princeton University Press, and a paper I presented

at the Brookings Institution yesterday. I note that I am here on my own behalf and do not speak for any organization.

Since before its founding in 1913, the Fed has engendered enormous controversy. People recognize that the Fed wields extraordinary power over the economy, but they do not always see how that power operates or who exactly is pulling the levers. This opacity has prompted reform proposals from the left and the right throughout the Fed's history.

The solution to this opacity seems plain enough: Turn on the lights, increase transparency, define the Fed's limits, and let the work of democratic politics drive the agenda for monetary policy in a clear and transparent way, as it does in so many other areas of our Government.

I am very sympathetic to this impulse. The Fed is the people's central bank and must, in appearance and in fact, make its policies on behalf of the entire people. But there is a unique tension in central banking that does not exist in other policy contexts.

In terms of democratic control over monetary policy, there can be too much of a good thing. The innovation of central bank independence or the separation of monetary policy from the day-to-day of electoral politics helps us as a democracy to take the long view when it comes to the value of our currency and the management of financial and economic crises and economic growth. Short-term political considerations are useful in many contexts, but managing the value of the currency has not historically been one of them.

The legislative task then is to balance this tension between the need, even the constitutional demand, to make the Fed democratically accountable without turning it into a political football that erases this institutional innovation of central bank independence. We must maintain that buffer between the day-to-day operation of monetary policy and the day-to-day of electoral politics.

The legislative proposals to reform the Fed currently pending before the Congress, as with literally hundreds of others that have preceded them, deal with the need to strike this balance with varying degrees of success. In general, these proposals come in two forms: they either deal with the functions of the Federal Reserve or with its structure. In other words, they seek to dictate macroeconomic policies or seek to influence the Fed's personnel.

I am generally more sympathetic to structural changes to the Fed than to functional ones. To illustrate, let me discuss very briefly two pending proposals: the Audit the Fed bill and Senator Reed's bill changing the governance structure of the Federal Reserve Bank of New York.

First, Audit the Fed. This is, as the saying goes, something of a solution looking for a problem. The Fed is, as Senator Brown already noted, already audited, its balance sheet increasingly transparent, its communications with the public increasingly frequent and clear. Indeed, the entire language of balance sheets and profits and leverage and equity are at best metaphors, at worst fictions, when applied to the Fed. And this bill would insert Congress into the day-to-day of monetary policymaking, a place that Congress has historically, rightly, decided to avoid.

Ironically, although most of the proponents of the public audit focus on combating inflation, the proposal risks institutionalizing

pressure to pursue the inflationary policies that usually command the strongest support in a democracy. Indeed, the first adopters of a public audit were not inflation hawks but employment doves.

Second, Senator Reed has proposed to subject the President of the New York Fed to Presidential appointment and Senate confirmation. I like this proposal much more. The New York Fed occupies a unique place in our financial system. It has a permanent vote on the Federal Open Market Committee, the only one without a Presidential appointment. And given its location, it supervises some of the largest banks in the country. That its President is selected in part by the banks it must regulate is, frankly, astonishing from a governance perspective. This governance structure feeds the popular impulse that the banking regulators do not work for the people. This view cannot be dismissed as a crank conspiracy theory. It finds support in the structure of the Federal Reserve Act itself.

Allowing the regulated banks to have this kind of direct, proximate control over their Federal regulators should be addressed. It makes the Reserve Banks something of the gall bladder of the financial system: they perform a useful but not essential function on behalf of the regulated banks in good times, but can allow the banks to introduce extraordinary risk into the system in bad. A public appointment at the New York Fed would balance the need to ensure that the Fed serves the public interest without eliminating the valuable buffer between the Fed and the daily press of electoral politics.

An alternative to this proposal would be to remove the bankers and their representatives from the Fed's governance structure completely and render the Reserve Banks fully subordinate to the publicly accountable Board of Governors. Regardless, the Reserve Banks' governance represents in appearance and in fact the kind of private influence over public goods that our political institutions are designed to prevent.

Thank you again for this opportunity. I look forward to your questions.

Chairman SHELBY. Thank you, sir.

Currently, the New York Fed President permanently holds Vice Chairmanship on the Federal Open Market Committee that you alluded to, with four remaining votes allocated to the other 11 regional banks on a rotating basis. Dallas Fed President Richard Fisher recently addressed the concern, and I will quote, and he says, "Too much power is concentrated in the New York Fed." He put forward a proposal that would, among other things, rotate the Vice Chairmanship and give the Federal Reserve Bank Presidents the same number of votes as the Washington-based Governors, save the Federal Reserve Chair.

To all of you, and, Dr. Taylor, I will start with you, do you support any of Mr. Fisher's proposals?

Mr. TAYLOR. I think that is a good start. He points to a problem about the New York Fed and proposes a solution which kind of equalizes across the other members.

Chairman SHELBY. Dr. Meltzer.

Mr. MELTZER. I agree with Mr. Fisher. My own proposal was that the Presidents of the Reserve Banks should be given the vot-

ing power because they are much more—the Boards have been changed over the years. They now have labor union representatives, women representatives. They are no longer banker boards, and they represent something much closer to the public interest than we get from the New York Fed, which represents the New York banks.

Chairman SHELBY. Dr. Kupiec.

Mr. KUPIEC. The New York Fed has enormous power within the Federal Reserve System. They have the closest contacts with the markets. They typically feed a lot of the market intelligence to the Board of Governors and control the information flow. So I think methods to level the playing field and make other parts of the country equally important. Some have discussed not just rotating the Vice Chairman of the FOMC, but actually moving the markets desk across different banks. This would give each bank access for a certain period of time and give access to the markets and have backup facilities available if something were ever to happen, God forbid, in New York or somewhere else again.

So I think it makes a lot of sense to diversify the New York power base across the system. Thank you.

Chairman SHELBY. Mr. Conti-Brown.

Mr. CONTI-BROWN. I also agree that this is a very good first step in the right direction. I would make two points, one of law and one of history.

Legally, the Federal Reserve Act does not dictate who will be the Vice Chair of the FOMC. That is determined by the FOMC's internal regulations. So it is only by convention and tradition that the New York Fed President is the Vice Chair. So President Fisher's recommendation could be instituted tomorrow by the FOMC.

Second, historically it is inaccurate, too, to say that the New York Fed has always had a permanent vote on the FOMC. Between the years of 1935 and 1942, it rotated along with the over Reserve Bank Presidents. So this is also something that has a precedent in history and something that I think—anything that would deemphasize the influence in perception and in fact of representatives of the financial industry in New York I think would be a step in the right direction.

Chairman SHELBY. Rules-based monetary policy. Dr. Taylor, you are well known for your work in developing a monetary policy rule known as the Taylor rule. We talk about it here a lot. You indicated in your opening statement that such a rule, whether it be the Taylor rule or another rule, would more effectively highlight the Fed's strategy, as you talked about. As you stated, Chair Yellen said that she would not be a proponent of chaining the Federal Open Market Committee in its decision making to any rule whatsoever. You mentioned several reasons why this should not be the real case.

Would you discuss in a little more detail how Congress could structure a monetary policy rule to allow flexibility and predictability, not to make monetary policy but to do proper oversight?

Mr. TAYLOR. I think the key is to require that the Fed describe, choose, its own policy rule, its own strategy. I think it also should be permitted to change it if circumstances change. The world is not

a constant place. And if there is a crisis, there is going to be a deviation from time to time.

Designing the rule, implementing the rule is the responsibility of the Fed. But the Congress has, I think, the role of requiring that the Fed have the strategy and describe it to you. I think that is the key to not micromanaging, not threatening the independence, but having the accountability and exercising the accountability that the Congress should have with respect to this agency.

Chairman SHELBY. Currently the Federal Open Market Committee transcripts are supposed to be released 5 years after meetings take place. Even with this 5-year lag, the most recent transcripts on the Federal Reserve Web site date to 2008.

This is a question for all of you. What timeframe do you think is appropriate, if you do, for the release of these transcripts in order to strike an appropriate balance between transparency and not compromising market-sensitive information? We should never want to do that. Dr. Taylor, we will start with you.

Mr. TAYLOR. I think a lot of studies show that the transcripts themselves and the releases have affected the nature of the discussion at the FOMC, and I think you have to recognize that transparency can go too far. You do not want to have C-SPAN broadcasting the meetings. So there has to be a decision. I do not think the 5 years has been shown to be any more problems than 3 years would. I think it could be closer in time. It would enable people to study important events like the financial crisis. We had to wait for quite a while until that happened.

I think that it is also important to try to make sure there is a consistency between more current things, like the minutes and the transcripts—the minutes and the transcripts are supposed to coincide with the same events. One is released before the other. But over time you can check the consistency between those. The minutes do give you a chance to see a little earlier; the transcripts are later. I think that would also go a way to improving the transparency without interfering with the decision making.

Chairman SHELBY. Dr. Meltzer, do you have an opinion?

Mr. MELTZER. The problem with many of these proposals is they do not look at what will be the circumvention. If you said you have to release your minutes at the end of a year, they would not have much information in them. That is, they just would not say it in a place where you could see it.

What I think the Congress needs to do, it needs to face up to its responsibility. Its responsibility is to be able to say to the Fed, “You told us you were going to do this, and you did not do it. Why?” And that is where the rule gives you leverage to do it, and that is more important—I mean, I know, Senator, a bill that wants to make more transparent the minutes of the Fed. Ask yourselves, suppose you had them, how would you be better able to monitor what the Fed does because you have them? My opinion is you would not. You have to get a discipline in the Fed to tell you what it is going to do and do it. That is, I believe—

Chairman SHELBY. That is more important, isn’t it?

Mr. MELTZER. More important than any other single thing that you can do. You do not have the ability now to monitor them.

Chairman SHELBY. You have a comment, Dr. Kupiec?

Mr. KUPIEC. Sure. I think the longer the lag in releasing the detailed minutes of the meetings, the easier it is to forget if the Fed sort of, you know, did the right thing or not the right thing. Five years is a long time. It is hard to remember what happened back then. Shortening the lag would increase accountability, I think, in some ways, but I think you have the information and the problems that you have heard Dr. Meltzer—

Chairman SHELBY. We just have to reach a medium which makes sense, would we not?

Mr. KUPIEC. It has got to be short enough that there is a memory for what was going on and whether they were discussing the right things and doing the right things. I mean, if you go back to what we find out before the crisis, you find out they were woefully uninformed, even through the summer of 2007 when subprime mortgages were blowing up and—

Chairman SHELBY. We found it out right here.

Mr. KUPIEC. Yes, and that is kind of scary. So, yes, there is a tradeoff there.

Chairman SHELBY. Mr. Conti-Brown.

Mr. CONTI-BROWN. The only thing I would add to echo these sentiments is the nature by which this information has been disclosed over time, so not only does the Fed disclose its transcripts on a 5-year lag, but its minutes after several weeks, and the decision itself after several hours, all of which are innovations in the practice of central banking within the last several decades. I think it illustrates a central point that I think is worth emphasizing, that central bank transparency under Chairman Bernanke, Chair Yellen, and Chair Greenspan has been expanding over time. So none of this is written in the Federal Reserve Act itself but is an innovation of the Fed.

Chairman SHELBY. Dr. Meltzer, I have a couple of questions I want to direct to you, if you would. You have written extensively—and you have testified here about this before—about the topic of Federal independence. One rough measure of independence you have cited is the portion of a budget deficit financed by issuing base money.

Could you elaborate on how this measure has changed in recent years? Does the Fed take actions today that threaten its independence?

Mr. MELTZER. Yes. I am glad you asked. When the Fed started, as I said in my testimony, they were not allowed to buy Government bonds at all under any circumstances. That was relaxed. Then they circumvented it so they could buy mostly Treasury bills, and until even through World War II, up to World War II, they bought mostly Treasury bills. And after World War II, one of the great Chairmen of the Fed, William McChesney Martin, wanted to institute, and did, bills only; the Fed would only buy bills. That is because he wanted a sound, secure, competitive bond market, and he thought the way to get that was to keep the Fed out of that market, because if they were in the market, they would dominate the market. And that had the great advantage that the central bank—the reason we had the original rule was the people back in 1913 understood that the great danger to a central bank is that it finances—it is used to finance the Government budget. That is

what they have been doing. They keep the interest rate low, and then they pay 90 percent of the interest that they collect back to the Treasury. So it does not cost the Treasury anything to finance these huge deficits, and it takes away any of the incentives we would have to begin to think about how over the long term are we going to solve the fiscal policy problem of the United States, with not just the budget deficit but something on the order of \$100 trillion worth of unfunded liabilities. I mean, that is a lot of money, even for a country like ours. And we are not going to be able to pay \$100 trillion for the unfunded liabilities.

So we need to find a human way to change the health care laws so that we take care of the indigent and we do not wreck the economy. And we are not doing that, and that is a problem. And if we wait until it becomes a crisis, then we will—as sure as God makes green apples, we will do something which will be draconian and harmful and difficult for the public.

Chairman SHELBY. A lot of us are very interested in greater accountability and oversight of the Fed, like any institution, but also we would like to strengthen the independence of the Fed. How do we do this?

Mr. MELTZER. I think a rule—think back to the period, not the very end but the years from 1985–86, when Alan Greenspan became Chairman, to about 2002. We had the longest period in our history, in the Federal Reserve history, of stable growth, short, mild recessions, low inflation. There were no complaints about the Fed. It was very responsible. It worked well. It operated more or less, not slavishly but more or less in response to the Taylor rule. That is what Greenspan did.

Why did it work better? Because one of the great mistakes that the Fed is pressured to make is it pays too much attention to the latest news and what is happening now; whereas, all of its abilities are to resolve longer-term, medium-term problems. And when he adopted the Taylor rule, he essentially adopted a medium-term strategy, and that worked exceedingly well, the best in the whole 100-year history of the Fed.

Chairman SHELBY. Dr. Taylor, do you want to add anything to that?

Mr. TAYLOR. Well, I agree, it is a period which economists focus on a lot. We call it the “Great Moderation” in the sense it has been smooth and had a long boom. And there has been debate about what it is, but I think Allan is—monetary policy is a big part of that, and they had followed a steady-as-you-go strategy, simple, people understood it, and it worked very well.

In fact, I could add something to this, Mr. Chairman. It is pretty clear to me when they started moving away from that is when things started being problematic in the economy. I have written a lot about that; especially around 2003, 2004, and 2005, that rate was held remarkably low compared to history, compared to the period Allan is referring to. There was excessive risk taking, a search for yield; the regulatory apparatus became a problem as well, and I think that was a big factor in the mess that we got into. And since then, it has been pretty much off again as well.

Chairman SHELBY. Senator Brown, you have been very patient. Thank you.

Senator BROWN. Thank you, Mr. Chairman. Always. Thank you.

Income inequality by some measures has reached its highest levels in perhaps nine decades. In 1983, the Fed began the survey of consumer finances. Thanks to this data, we can see that the wealth gap has widened for white families compared to nonwhite families over the past 30 years. I apologize to Senator Warren and Senator Donnelly for not being able to see this, but you already know this stuff because you are so prescient, both of you.

It seems to me the Fed has cared about these issues for some time. I think it is entirely appropriate, as the strength of our economy should not and I think cannot be divorced from how families are faring.

I would like to hear your views, each of you, starting with Dr. Taylor, if you would. Do you think the Fed should care about wealth and income inequality? Is that something in the purview of the Fed to care about?

Mr. TAYLOR. Yes, I think individuals on the Fed, like anybody else, are concerned about it. I am concerned about it. I think as an institution it is very important, especially independent institutions, to have limited purposes. It cannot solve every problem in America. And what has happened in some sense is an independent, limited-purpose organization has begun to expand its scope. Allan Meltzer mentioned a number of those things. The goals of the Fed—price stability, as suggested by the Congress, employment, low interest rates, all those things—those are the macro responsibilities that they currently have at this point in time.

I believe that as an important part of our overall economic policy, if we get that right, if we get that macroeconomic part right, monetary policy right, then there are a lot of things that public policy can do to address the problem that you are referring to here.

I have written about it. We probably all have written about it. There is tax policy. There is regulatory policy. Growth itself is so important. Our growth rate in this expansion has been 2.2 percent. I think a lot of that is because of policy. We would help this income distribution tremendously if we had better opportunity for people at the lower 30 percent to grow and thrive with more jobs and better jobs. It seems to me that should be the focus. The Fed should focus on what its responsibilities are. We have other instruments of Government. It is an allocation of responsibility. It is a governance issue. It is what has worked well in the past, and I think we should continue with that overall approach.

Senator BROWN. Thank you. Before Dr. Meltzer, just to be clear, employment—you said employment, suggested by the Congress. It is actually mandated, as you know, the dual mandate. It is not just suggested by Congress.

Dr. Meltzer, your thoughts? And I am not sure from Dr. Taylor's comments if he thinks that income inequality should be a purpose of the Fed to address that. I understand that—or one of the purposes. I was not entirely clear. If you could be as specific as possible.

Mr. MELTZER. The Fed, like any organization, does its best work if it has a single motive to go to. If we give it many different motives or objectives, we spoil its path.

I am glad you asked the question because I think this is a subject on which I am currently working, which I am very interested in, and think is really a major issue for our country. Redistribution has not helped to spread the distribution of income. As a matter of fact, it worsens it.

Just ask yourself, if redistribution was the way to equalize incomes, France would be the richest and most equal country in the world. Instead, it is lagging behind many of its neighbors.

Ask yourself this question: How did your relatives, my relatives, get to be from immigrant status to middle-class and wealthier status in many cases? They came here ignorant, lacking in skills. They took jobs. When they took those jobs, output went up. But the distribution of income widened because they were getting low pay. My first job in a major company was 25 cents an hour. I do better than that these days.

How did they get to the middle class? They got there by learning on the job. Companies trained them, so they learned more. And as they learned more, output expanded, but productivity went up. And as their productivity went up, their wages went up. That is the way—

Senator BROWN. Well, let me interrupt—

Mr. MELTZER. —we get a middle class.

Senator BROWN. We do have limited time. Correct, except look at the charts, which we do not have here, since 1973—

Mr. MELTZER. Because we are not investing—this is the lowest rate of investment of any postwar business cycle. It is the lowest rate of productivity growth. That is why the middle class—

Senator BROWN. But there has been such a disconnect between productivity growth and income growth, and you can blame that on Fed action, inaction, or other things, but it is clearly more complicated than that.

Mr. MELTZER. One of the things that the welfare State does, which is counterproductive, is it does not get them to make those steps which are important, that is, to go from the first job, learn on the job—

Senator BROWN. I am sorry, Dr. Meltzer. It is hard for me to blame—it sounds like you are blaming the worker who is increasingly productive for not being smart enough to share in the wealth he creates for his employer. But that is far afield. Let me go on in this question. I apologize.

Dr. Kupiec, your thought on the Fed's role in dealing with income inequality?

Mr. KUPIEC. Yes, I think income inequality is an important problem for everybody. I am not sure how you exactly work an income inequality mandate into a monetary policy decision making role. Here you have income inequality by race. I do not know how you tell the Fed to do monetary policy according to race. That makes no sense to me. But I would say that Federal Reserve monetary policy largely works by redistributing income. Right now retirees and savers make nothing for 6 years now; whereas, borrowers are encouraged—borrowing is very cheap. So the Federal Reserve and monetary policy plays a role in the distribution of income, but it is not always the one that encourages the distribution you may like to see in the end.

Senator BROWN. Mr. Conti-Brown.

Mr. CONTI-BROWN. So, in a word, yes. The Fed should and does and has focused on income inequality. There is the Jackson Hole Symposium hosted by the Kansas City Fed each year. In 1998, its theme was income inequality, and then-Chairman Greenspan gave a very good speech talking about how income inequality as a topic of conversation among economists should be brought out from the cold, and I agree with that. And I think that Chairman Greenspan and since then Bernanke and Yellen have done well by focusing on this issue. I do not think that anyone is saying that interest rates should be dropped for the redistributive consequences among debtors and creditors in order to adjust the chasms between different sections of our economy. I think instead it is to understand what are the consequences of this kind of income inequality to the mandates that the Congress has given the Fed. I think to ignore that, to say that income inequality is outside of our bailiwick, is to ignore the very clear connections that income inequality can have on price stability, financial stability, and maximum employment.

Senator BROWN. Thank you, Mr. Conti-Brown.

Let me go to the Audit the Fed issue more directly. You described the proposals in your opening testimony as solutions in search of problems. On the other hand, it is hard to argue against more transparency and accountability. Why not ask the GAO to audit their monetary policy? How do you argue against more transparency that you have all talked about?

Mr. CONTI-BROWN. Right, I mean, you do not argue with the importance of transparency. The question that is important here is: Do we want to throw organizational complexity at one of the most organizationally complex agencies of Government? So putting the GAO into the business of both evaluating and, frankly—as there is not much difference between evaluation and implementation—and implementing monetary policy strikes me as a very dangerous idea. It adds, frankly, and ironically, opacity to this organization rather than taking it away.

I think that is why focusing on governance structures so that we have a clear line between the people, their representatives in the Senate and the House, and then through the Congress to the Fed is better so that we know when as citizens there is something that we like about the Fed or do not like about the Fed, we have a clear mechanism of conveying that. When we separate those powers among different organizations within Government, it can muddy those waters and make it less clear whom we should hold accountable.

Senator BROWN. Dr. Meltzer, be specific, if you would, about your thoughts about the Audit the Fed proposals.

Mr. MELTZER. I think you do not get what you want. Suppose you knew everything. Suppose you found out that the Fed chooses its policy using a Ouija board. What would you be able to do with that?

What you want to do is get something which permits you to see that the policies that are carried out are carried for the benefit of the public. Knowing how they make those decisions—let me give you an example. There is a rule now—it may be a law—that says if three members of the Fed meet together, they have to consider

it a meeting. So three members of the Fed do not meet together. They circumvent the law. That is not going to get you the information you want. The information you want has to come from having something very deliberate that you know they are going to do and that they tell you they are going to do, and you are able to say, "You did not do it," or, "You did."

Senator BROWN. Thank you. One last real quick question, Mr. Chairman.

Last week, during congressional testimony after Chair Yellen was here, she testified at the House Financial Services Committee, and she was criticized, in part, by, I believe, the Chairman and a number of other House members for meeting with Secretary Lew, although Chairman Bernanke met apparently weekly with Secretary Geithner during his tenure. Just a yes or no question, starting with you, Dr. Taylor: Do you believe the Chair of the Federal Reserve should meet with the Secretary of the Treasury?

Mr. TAYLOR. Yes.

Senator BROWN. Dr. Meltzer.

Mr. MELTZER. Sure.

Senator BROWN. Dr. Kupiec—

Mr. MELTZER. Let me say that President Wilson at the start of the Fed would not invite Fed Governors to social events at the White House because he did not want to influence them. But I believe that they should meet because they have common problems.

Senator BROWN. OK. Dr. Kupiec.

Mr. KUPIEC. Yes, but there should be a balance of interaction between the executive branch and the Congress, I think. And I think it is probably overweighted to Treasury.

Senator BROWN. Mr. Conti-Brown.

Mr. CONTI-BROWN. Yes.

Senator BROWN. OK. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman.

I am not sure if this is anecdotal or exactly how accurate it is, but I recall the statement that between 2009 and the end of 2013, there was an increase in the employment rate among financial institutions in this country by over 300,000 individuals being employed. You would normally think of an increase in the employment rate as an increase in productivity, but that has not happened, specifically because the vast majority of that 300,000 was in the area of compliance. The Federal Reserve has, among other things, a responsibility for the regulatory aspects within the banking industry—not alone but, nonetheless, a part of it.

I was going to ask Dr. Kupiec—and I hope I am saying that correctly—in your testimony you make the point that the Federal Reserve does a lot more than set monetary policy. It is also a major financial regulator. This means that the Federal Reserve essentially has two sides: setting monetary policy and financial regulation. Giving the Federal Reserve the freedom to set monetary policy is important, but how can we preserve that freedom while making sure that their regulatory decisions are just as accountable as any other Federal agency?

Mr. KUPIEC. Well, some people think the Fed should be stripped of its regulatory authority and those regulatory authorities should be given to other agencies. That is probably the most extreme view.

The Congress has the complete ability to audit the Federal Reserve on its supervision activities. They are not restricted in any way by any law, by the GAO or otherwise, on hearings or other things, to audit the Federal Reserve's regulatory activities, at least to any degree I can find in the law.

Senator ROUNDS. Would you suggest that it is simply a failure on the part of the Congress to exercise that authority?

Mr. KUPIEC. I think since the Dodd-Frank Act has come into being, the Federal Reserve has extensive powers that it did not use to have, and I think the case for much more congressional oversight now is far stronger than it was in the past.

Senator ROUNDS. Thank you.

Dr. Meltzer, if I could, I find your comments refreshing, and as I have watched, I think your message suggesting that there are some limitations that the Fed has with regard to being able to fix issues within our society is something that you point out, and I think you did a very nice job, sir. And I thank my colleague Senator Brown for that question.

I noticed that the table that they provided showed only up through the year 2010. It would be interesting to have observed what the changes might have been between 2010 and 2014 as well.

But for you, sir, if you could, in the year 2012 you wrote that for 60 years, from the mid-1920s through 1986, the Federal Reserve's minutes showed almost no discussion of policy issues. You then contrasted this with the Fed's recent actions on quantitative easing. Are you concerned that the Fed is becoming more reactive to short-term changes?

Mr. MELTZER. Yes, much too reactive to short-term changes. I have been a practicing economist for 57 years. The one thing that I have certainly learned is economics is not the science that tells you good—gives you good quarterly forecasts. There is no such science. There is just too much randomness in the world to be able to predict accurately what happens from quarter to quarter. So to improve what we do, we should look over longer terms. We can do a lot of good for the public if we get them on a stable path. We do not do that.

I will give you an example, which you are all familiar with, I believe. The Fed for many years in recent times—it has given it up now—concentrated its attention on the growth in the employment rate that came out every month. The report would come out; it would go up, the market would boom. People would be very happy. The same number would be revised the next month, and it would be lowered.

Now, what was the point of concentrating on changing the policies on the basis of a number which was largely a random number that got it right. Instead of saying, look, our objective is to get back to full employment with low inflation, and this is the way—we know how to do that. But we do not do it. We concentrate too much on the short term.

Senator ROUNDS. Thank you.

For Dr. Taylor, in your testimony you talk about the importance of having a transparent and predictable rule to guide the Federal Reserve policy. Sometimes it can be easy to forget that the Federal Reserve decisions impact Main Street as much as if not more than Wall Street. I know that several of Members of the Committee have also suggested the need for a rule, and I would invite you if you would begin. How can you discuss—or can you discuss how the Taylor rule would help to create economic stability and what it would do for Main Street businesses and consumers? And then I would open it up at that point for other Members if they would also like to comment on it. Dr. Taylor?

Mr. TAYLOR. One thing is the predictability itself. It is important because so much of policy becomes unpredictable and hard to interpret. There is uncertainty, business decisions and life decisions that are based on some sense of certainty, so a more rules-based policy would deliver that.

I think the best thing, though, for communicating about this is history and the fact that, as Allan Meltzer mentioned, we have had so much experience in the U.S. and other countries when policy is more predictable, monetary policy in particular, when it is rules-based, the economy works better. People know what is happening. It is more reliable. In a sense, the decisions are easier. We can see that in the United States. You can see it in other countries. You can see it in emerging markets. There is just a tremendous amount of evidence for that. And I think from people who do not follow the Fed every day, it just kind of makes sense. Here is what they do.

One of the things I found years ago in making proposals, central bankers, who were just maybe appointed to be president of their bank, and somebody from out of the country would come and they said, “Well, this is terrific. Now I kind of know what to do. I did not know that.” You know, here is a description which is fairly easy, and then they talk about it to people in their country. It is amazing. All over the world this is happening.

So we have a lot of experience with this. In a way it makes common sense. I tried to quote people like George Shultz, Janet Yellen herself has found this, this kind of experience. So there is just tremendous evidence for this. And I can refer to academic studies, compare different periods of time when things worked better. But ultimately it comes down to common sense. An independent agency should have limited purposes, it should be accountable. You can see it better. Allan Meltzer says just having an audit, just having earlier release of transcripts or minutes is not enough if there is not a description of what their strategy or their rule is. And I would say I cannot see why someone would object to an independent agency describing its strategy. What is the problem with that? You are not telling it what the strategy would be. You are saying just tell us your rule, tell us your strategy. I think it would work a lot better.

Chairman SHELBY. Dr. Meltzer, do you want to comment on that?

Mr. MELTZER. Yes, I want to make a very simple point. Last week, Stanley Fischer, whom I admire greatly and who is a good friend, gave a talk at the Chicago Federal Reserve Bank. In it he cited what was accomplished by \$4 trillion worth of QE. He said,

“We lowered the unemployment rate by 1¼ percentage points.” The rest of the drop in the unemployment rate is something about which we should be very concerned. We for a long time have had people, men over 60, dropping out of the labor force. We now have men 18 to 34—and women, too, presumably—dropping out of the labor force. They do not get training. They do not learn on the job. They do not have productivity growth. They are a problem for our future. That is what the Fed accomplished with \$4 trillion?

Senator ROUNDS. Mr. Chairman, I believe my time has expired. Thank you.

Chairman SHELBY. Thank you.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, and thank all for being here.

During the financial crisis, Congress bailed out the big banks with hundreds of billions of dollars in taxpayer money, and that is a lot of money. But the biggest money for the biggest banks was never voted on by Congress. Instead, between 2007 and 2009, the Fed provided over \$13 trillion in emergency lending to just a handful of large financial institutions. That is nearly 20 times the amount authorized in the TARP bailout.

Now, let us be clear. Those Fed loans were a bailout, too. Nearly all the money went to too-big-to-fail institutions. For example, in one emergency lending program, the Fed put out \$9 trillion, and over two-thirds of the money went to just three institutions: Citigroup, Morgan Stanley, and Merrill Lynch. Those loans were made available at rock-bottom interest rates, in many cases under 1 percent, and the loans could be continuously rolled over so they were effectively available for an average of about 2 years.

Now, in Section 1101 of Dodd-Frank, Congress said no more back-door bailouts. It recognized that the Fed should still serve as the lender of last resort, but that there should be strict limitations on its emergency lending authority so that big financial institutions could not count on the Fed to bail them out if they made a bunch of wild bets and then lost.

Now, recently, the Fed released a proposed rule implementing Section 1101. Dr. Meltzer, do you think that the Fed’s proposed rule on emergency lending prevents back-door bailouts as Congress intended?

Mr. MELTZER. No. I congratulate you, Senator Warren, for keeping this issue alive. It is a disgrace that we have got so much money thrown at such low interest rates at so few banks. And the Dodd-Frank Act in its heart may talk about getting rid of too big to fail, but at the heart of the Dodd-Frank Act, the Secretary of the Treasury is authorized to do exactly what Secretaries of the Treasury have been doing for years.

The way to get out of that is to get the Fed out of the too-big-to-fail business, pass the Brown-Vitter bill, which says the bank is responsible for its errors, make it have capital.

Now, why did we move away from that? See, we started with the idea that the Government’s responsibility was a legitimate responsibility to protect the payment system. We have shifted that to where it protects the banks. We want to go back to protecting the

payment system, and we want to get them out of the too-big-to-fail business.

Senator WARREN. Thank you, Dr. Meltzer. And what I want to do for just a second is stay focused on Rule 1101. You have got the larger picture, but I want to stay on this part, because there is a rule pending right now from the Federal Reserve Bank.

Last August, I joined with Republicans and Democrats to send a letter to the Fed urging it to strengthen its emergency lending rule. Three others on that letter are on this Committee: Ranking Member Brown, Senator Vitter over there, and Senator Cotton. And the letter included some specific ideas for strengthening the rule, trying to prevent this form of back-door bailout. It will not stop them all. We have got a lot of things we need to work on, but this one.

So, Dr. Meltzer, I just want to run through some of the ideas that were in our joint letter and ask you if you could just briefly give your thoughts on them.

One suggestion, establish in advance that any emergency lending will be offered at a penalty rate, not a rate well below market rates.

Mr. MELTZER. Yes, because that leaves, for example, the example of banks taking the money that was pushed on them, insisted upon, and use it to buy up other banks.

Senator WARREN. All right. The second one, establish in advance that emergency lending would not be available to any institution at or near insolvency.

Mr. MELTZER. Yes.

Senator WARREN. Good. Third, establish in advance that an emergency lending program is for a systemwide problem and used by a number of institutions large and small, not just to bail out one or two giant institutions.

Mr. MELTZER. Yes, that is a way of protecting the payment system, which is essential for the maintenance of the economy. But it is not important. There is—if we have the right set of rules, we do not have to worry about bank failures any more than we have to worry about corporate failures.

Senator WARREN. Thank you, and let me just try a fourth one here. I am a little over time, but if I can do a fourth one, establish in advance that any lending facilities would be made available only for a short, defined period of time so that banks could not excessively roll over the loans.

Mr. MELTZER. Good.

Senator WARREN. Good. Thank you. Thank you very much, Dr. Meltzer. This is a critically important aspect of Dodd-Frank that the Fed has just glossed over. If big financial institutions know that they can rely on the Fed to save them if they start to falter, then they have every incentive to take on more risk and to threaten the entire system. These rules are not yet final, so the Fed still has an opportunity to place real limitations on its emergency lending. But if the Fed fails to do that, I believe Congress should act.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman. And I want to continue this same line of discussion because I strongly agree with it.

My biggest concern in this whole space since the crisis, including Dodd-Frank, including Fed action or inaction, is what I think is clearly the continuation of too big to fail. Just by the numbers, concentration in our banking system has grown significantly. The four largest U.S. banks are 25 percent larger by assets today than they were in 2007.

According to FDIC, the top four control 43 percent of all the assets. The top six U.S. banks have assets equal to about 63 percent of the U.S. economy. So just by the numbers, the threat is greater. Let me first—

Mr. MELTZER. We are creating monopolies.

Senator VITTER. Yes. Let me first ask all four of you, do any of you consider that trend either positive or neutral, not necessarily negative?

Mr. MELTZER. Negative.

Senator VITTER. Anybody else disagree with that?

Mr. TAYLOR. No.

Senator VITTER. OK. Do any of you think if one of those mega-institutions were threatened today, they would not essentially be bailed out, that they would not have emergency lending authority or some other means to continue without serious repercussions? Anybody want to offer an opinion?

Mr. MELTZER. They would be bailed out.

Senator VITTER. Anybody disagree with that?

Mr. TAYLOR. Yes, with the current situation, they would. I think there are some things that can be done, but in the current situation it is, unfortunately, very likely.

Mr. KUPIEC. I would say it would depend on circumstances. I think if one very large institutional loan would get into trouble, people might use Dodd-Frank powers and put that through a liquidation, one in isolation. But the probability of that happening is nil. It is probably a crisis situation and all of them are weak. So I take your point.

Mr. MELTZER. Senator Vitter, let me just take a minute to explain to you why I am sure that would happen. The Secretary of the Treasury would be confronted—would meet with his staff. They would tell him all the things that could happen, disastrous things. They do not know they are going to happen, but if you were the Secretary of the Treasury, if I were the Secretary of the Treasury, and someone came in and said take a risk, what would you do? We have to set up arrangements under which that will not happen. We cannot just depend upon the will of the Secretary of the Treasury, because he will be under pressure and he will know or be told that terrible things will happen if he does not do the bailout.

Senator VITTER. Right. Mr. Conti-Brown.

Mr. CONTI-BROWN. The only thing I would add—and I agree. I mean, the scenario you are describing is exactly what Dodd-Frank is designed to address. This would be not the trial run, the actual performance of Dodd-Frank liquidation authority. And I agree with my copanelists and with you, Senator Vitter, and Senators Brown and Warren, that I think the capital levels of banks today are so low that I can hardly imagine even if it were a one-off situation with one of these multitrillion-dollar banks, that we would see a

seamless operation of the orderly liquidation authority. And so this is also a great concern for me.

Senator VITTER. Thank you. That is a perfect segue to my next question. As you know, in broad terms, I think the best response to avoid that is higher capital requirements for the megabanks.

How do each of you feel about the current—now, that requirement has improved, moved in the right direction. I do not think it has moved enough. How do each of you feel about the current capital requirements for very large banks?

Mr. TAYLOR. I think higher capital requirements are a way to get at this problem, and it may be the easiest way. But there are other ways, too, which I would just make a short pitch for. There is something in our Bankruptcy Code that could be amended and reformed to actually allow one of these institutions to go through bankruptcy and not cause a mess. There is a proposal called Chapter 14. One version came out of the House. Senator Toomey has been involved with another one here. I think it is really a good reform. It needs to be done anyway, and that would enable the Secretary of the Treasury, or whoever has to make this tough decision, to say, No, you know, staff, there is a chance this is going to happen, but we have got this other approach. We have got this bankruptcy thing that even a large institution can go through. That, I think, coupled with these capital requirement changes, could improve the situation a lot.

Senator VITTER. And I am very open to that, and you certainly agree those are not mutually exclusive. They can work together. Dr. Meltzer.

Mr. MELTZER. You certainly know my position on this, Senator Vitter. You know, it is really, as I see it, a fundamental economic question, and that is, who will have the incentive to do the right thing at the right time—the people whose money is at risk or the people who regulate them? The answer is the people whose money is at risk.

Senator VITTER. Thank you.

Dr. Kupiec.

Mr. KUPIEC. The current system of capital regulation we have got ourselves into is incredibly complex. It is hard to even know what the requirements are for firms. In fact, most of the large firms' capital requirement is being set by the Federal Reserve CCAR stress test, which is about to happen next week when the Fed—but we do not even really know objectively what the capital rules are. So while I am for higher capital, I am for much more simple, straightforward, objective measures of capital that regular people can understand, that you do not need a—

Senator VITTER. Also, I agree with that, too.

Mr. KUPIEC. You do not need 100 Ph.D.s to read through the rules.

Senator VITTER. I agree with that, too.

Mr. Conti-Brown.

Mr. CONTI-BROWN. I am not even sure a Ph.D. helps you read through some of the capital rules that we have. And so I think it is true that Basel III does make significant improvements, but tripling very little just still leaves you with little. And here I think substantial, dramatic increases to capital would go a very long way,

and the reason, of course, is very simple. Debt is the contagion in a financial crisis. When there is uncertainty about the value of assets and questions about who owes whom what money and what are the consequences to the financial health of the firms interlocked together, that is the financial crisis. When equity plays a much greater role, well, that is the very nature of the contract that shareholders have entered into. And so I think this is a simple and clear solution that is not mutually exclusive with the Bankruptcy Code, and I would flag one other issue on the Bankruptcy Code. I think there are other exceptions besides even a Chapter 14 where assets and transactions have been written out of the Bankruptcy Code in derivatives and other kinds of financial markets that should be written back in so that we have a much clearer sense in the event of bankruptcy of who owes whom what and how they can participate in a more organized way without circumventing that and getting first in line just because your lobbyists before Congress were more effective than the other guys.

Senator VITTER. Thank you all very much.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Donnelly.

Senator DONNELLY. Thank you, Mr. Chairman, and I want to thank you all for being here.

I just want, Mr. Kupiec, to talk about another subject for a second. The International Association of Insurance Supervisors is attempting to develop capital standards for internationally active insurance groups. There is a concern that these proposed global capital standards could be adopted by Treasury and the Federal Reserve. And in my State, Indiana, we have lots of insurance companies governed by State regulation, and there is a concern.

So what I am wondering is, as you look at this, do you believe that the process that is going on could endanger the State-regulated insurance system we have had for over a hundred years here?

Mr. KUPIEC. Yes, I think this is a big issue, and it really needs to be looked into. The entire insurance regulatory system in the U.S. is based on State insurance regulation, and it has served us well for many, many years. The problems that arose in the crisis with the one insurer, AIG, were not in an insurance subsidiary. It happened in London in a special financial products group that was not considered insurance, and, in fact, that products group was actually subject to regulation by a bank regulator, the Office of Thrift Supervision.

So the insurance system that exists is—now actually many in the industry feel threatened by the developments. The Federal Reserve now has powers over the insurance companies that are affiliated with depository institutions. They got this power under Dodd-Frank when they inherited insurance holding company and savings and loan holding company supervision from the Office of Thrift Supervision. And the Federal Reserve has testified that they have a very large examination program going into State insurance firms and examining them. And prior to this, these firms were under the examination authorities of the State supervisors.

More than that, the Federal Reserve has been applying bank holding company capital rules to these groups, and so if they look at an insurer and they think of it through a bank capital prism,

they say that insurer's capital is low. Well, in fact, the insurer meets State capital regulations which are defined for an entirely different purpose than bank capital regulations, and it is completely well capitalized. But the Fed will look at the group and say the capital is too low, apply the bank capital standards and require the group to raise capital. So insurers that have depositories as affiliates are finding real problems here. They are finding their capital constrained by the Federal Reserve, who was never intended to be their primary supervisor.

Senator DONNELLY. Well, obviously, I am proud of our companies in our State, and we have found that our State regulation system has worked pretty well over the years.

Dr. Meltzer, I want to ask you something. I am just curious. Let me paint a little picture for you. In 2009, Elkhart County, Indiana, 20-percent-plus unemployment; Howard County, Indiana, 20-percent-plus unemployment. We build Chrysler transmissions in Howard County. We build recreational vehicles in Elkhart County. Today unemployment, 5.5 percent in both places. Do you think that was done in a bad way?

Mr. MELTZER. No, I do not think that is—that is only good. I mean, I certainly think—

Senator DONNELLY. I have sat with the families when they did not have jobs and when they did have jobs.

Mr. MELTZER. Yes.

Senator DONNELLY. And when I look up today from where we were at the time we had the collapse, it is a completely different world for these families.

Mr. MELTZER. I agree that reducing the unemployment rate is a desirable thing in itself. What we are perhaps differing about is how much of that is due to the Fed's QE policy and how much of it is due to other things that were going on, like a drop in oil prices.

Senator DONNELLY. The oil prices did not get the transmission workers back to work. That was the assistance of the Federal Government.

Mr. MELTZER. Good. But the Fed or the Federal Government—

Senator DONNELLY. Oh, I did not say the Fed. I am just saying, overall do you see that as something that actually benefited the country?

Mr. MELTZER. Of course it is good. I mean, there is no question that low unemployment is desirable, and it should be and is an objective that we should try to meet all the time.

Senator DONNELLY. OK. Let me ask you one other question, and this goes against the rule I learned as an attorney to never ask a question you do not know the answer to, and that would be: How do you define redistribution? I was curious when you were talking about that, and you said this redistribution is a problem. How do you define redistribution?

Mr. MELTZER. When you tax high incomes in order to pay benefits to low incomes.

Senator DONNELLY. What was the tax rate under Eisenhower?

Mr. MELTZER. Oh, it was around 70 percent—

Senator DONNELLY. What is it today?

Mr. MELTZER. —coming out of the war. But ask yourself the next question: How many people actually paid that tax?

Senator DONNELLY. Enough to build the roads at the time.

Mr. MELTZER. Not so much.

Senator DONNELLY. They did pretty good, as far as I could tell.

Mr. MELTZER. I do not believe that taxation is the major problem. I believe regulation is the major problem. Regulation is what is hurting our economy. Regulation is what is deterring business investment. You want to worry about—both for the near term and the longer term, you want to worry about the fact that we are not getting much investment, and much of the investment that we have been getting was in the oil and gas industry, which is now going temporarily to be reduced. Investment leads to productivity growth. Productivity growth leads to middle income going up. The best way that we can get the income distribution to collapse is to increase Part D growth by getting corporations to invest more.

Senator DONNELLY. OK. I am out of time, so thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Dr. Meltzer, with respect to Dodd-Frank, you have written, and I will quote, “The Federal Reserve made the mistake of accepting responsibility for writing rules to increase financial stability. Some among them should know that the Federal Reserve had failed to require prudential policy in the years preceding the 2008 crisis.”

Are you concerned that such failures could happen again?

Mr. MELTZER. Absolutely.

Chairman SHELBY. Should we reconsider some of the authorities granted regulators under Dodd-Frank that were intended to enhance or preserve financial stability?

Mr. MELTZER. Yes. The key to the Brown-Vitter bill, which I have tried to work on with Senator Vitter, talked to Senator Brown, the key to that is to give the incentives to do the right thing, to be prudent in your choice of policies and actions, to do that on the people who have the most at stake, and that is the bankers and their principal stockholders.

One of the things—I was glad that Senator Vitter brought up the problem of the concentration in banking because it is a problem. Here is a fact that was told to me by a banker friend. To meet one of the regulations, they hired temporarily 1,000 attorneys to do the thing. Now, what does a community bank do under those circumstances? What does a small or medium-sized bank do under those circumstances? It sells out to the big banks, or it goes out of business. It cannot afford to pay those costs. That is why we are getting concentration in the banking system that he talked about.

The best way to get rid of that is to go and put the responsibility on the bankers. Take off the Dodd-Frank emphasis on having the Fed regulate them. Put the responsibility on them to regulate themselves.

Chairman SHELBY. The effect of financial regulation on liquidity, financial regulatory reforms put in place, as you all know, have added thousands of pages of rules and regulations that have vastly increased compliance costs and liability for banks.

On the one hand, the Fed’s easy money policies over the last few years were supposed to stimulate the economy. On the other, we

now have draconian rules, for example, on when and how banks can lend.

I will point this question to you, Dr. Meltzer and Dr. Kupiec. Do you agree that the regulatory burden on financial institutions has limited the effectiveness of the Fed's monetary policy actions?

Mr. MELTZER. I am not sure.

Chairman SHELBY. Dr. Kupiec.

Mr. KUPIEC. I think it has. There is an interesting phenomenon going on now where you find the Fed has created all this liquidity and deposits, and the largest institutions now are about to be charged negative interest rates to get the banks to hold their deposits, and this is a consequence actually of the new liquidity regulations that are going into place. The liquidity regulations require banks to treat large deposits as if they will run in a 30-day period under the liquidity coverage ratio, and the bank has to have investments to offset that run. Currently the investments pay almost nothing because of the zero interest rate policy, so you have the large banks basically posting these programs where they are telling people to take deposits out of the banking system. So we have this very strange new world where regulation that is meant to cause banks to be liquid is actually encouraging the banks to get deposits out of the banking system.

Chairman SHELBY. Dr. Kupiec, what are your views on the way the Federal Reserve is currently conducting stress tests? Do you have any recommendations to make the tests more efficient, transparent, and perhaps effective?

Mr. KUPIEC. I think auditing the Federal Reserve stress test process would be a very good first step to understanding—for the Congress to understand whether they think it is a cost-effective means for regulation.

In my own opinion, doing stress tests for a number of years and the head of the FDIC group that contributed to stress tests, both at the FDIC and the Federal Reserve System, and getting economists to their CCAR process, I can tell you these tests are very subjective. There is no right answer. It is really a game where you go in and you try to guess what the Federal Reserve thinks the losses are going to be under these scenarios, and you never know what the right answer is. It is almost impossible to plan long-run business planning in a situation where you have no idea what the rules of the game really are, and the regulator can change the rules of the game at the last minute.

So I think these rules are very unproductive, and I think they give us a false sense of confidence, and they give a lot of discretion to the Federal Reserve Board and take it away from the banks.

Chairman SHELBY. Dr. Taylor, we have been using—or it has been used, Let us audit the Fed. A lot of people associate audit with just running the numbers and so forth. But what I took from some of your statements and others' in this way, basically we ought to do great oversight of the Fed and their policies, not be a member of the Board of Governors, not to make that policy, but to do the proper oversight that Congress should have always done. Is that what we are saying here?

Mr. TAYLOR. Very much so, Mr. Chairman. It is require that the Fed specify its own strategy in a way that you can hold them to,

and in hearings, in written statements, and, again, give them the flexibility they would need to implement that.

Chairman SHELBY. Do you agree with that, Dr. Meltzer?

Mr. MELTZER. Absolutely. I mean, there should be a law which says choose your strategy—very much like the House bill, choose your strategy, compare it to the Taylor rule or some other rule—

Chairman SHELBY. Sure.

Mr. MELTZER. —and we will monitor you.

Mr. KUPIEC. I very much agree, and I think part of the transparency issue is understanding whether the decisions the Federal Reserve Board makes at the time it makes the decisions, do they actually perform the way the Board thinks they perform, or have some accountability, some measure of whether their judgments at the time are really working or not. If you find out over time they are not working, then you have to change something about the system to improve that, and I think that is the Congress' job.

Chairman SHELBY. So when we talk about audit, we are really talking about responsible oversight, aren't we?

Mr. KUPIEC. That is very much what we are talking about, not an audit but oversight.

Chairman SHELBY. Thank you.

Senator Brown.

Senator BROWN. Thank you, Mr. Chairman. I very much appreciate your distinction between auditing—and I remember what Chair Yellen held up, the book of the audits of the Federal Reserve—and oversight, and I think you are dead on.

A couple of comments and a couple of last questions, Mr. Conti-Brown. We talk about not just reforming the Fed. I think it is important to remember what Senator Vitter said, what Dr. Meltzer echoed, what Senator Warren said about the increasing economic power, if you will, of the regulated, the six largest banks, the eight largest banks, wherever you want to start the cutoff there, do the cutoff, and not just the economic power that six banks having 65 percent—their assets being 65 percent of GDP, but the political power that they hold with agencies, with regulators, with Congress, all up and down.

The second thing I thought of during this hearing—and it has really sparked interest in my office and among my staff and among the Banking Committee staff, Graham and Laura particularly, is sort of the structure of the Fed and the 12 regional Presidents and the 12 districts, how each of the Class A—each of the three Class A Directors are drawn from the banks, each of the Class B Directors are chosen by the banks, and each of the Class C Directors are chosen we do not really quite know how, ultimately by the Fed, but we do not know where names are submitted, and the statute does not seem to speak to this at all clearly, and it raises a lot of questions about sort of the most—the potential of regulatory capture and the fact—and I think the question that I asked all of you that you all answered fairly well about, you know, should the Fed be interested in income inequality, and when the nine—typically, the nine Class A, B, and C Directors in each of the Fed regions, in each of the Fed districts, who have hired—six of whom have hired the Fed Presidents in those district, how they are not exactly a cross-

section of America in their income and their backgrounds and their education levels, perhaps in their interests also.

But let me talk for a moment about the Taylor rule and ask you, Mr. Conti-Brown, some thoughts. Dr. Simon Johnson at a hearing in the House some months ago made clear there is a significant difference between central banks being transparent about their objectives and actions for monetary policy and Congress specifying in detail a default rule for determining monetary policy for a central bank. Dr. Taylor 20 years authored an article that we know about titled, "Discretion Versus Policy Rules and Practice". He wrote, "A policy rule can be implemented and operated more informally by policymakers who recognize the general instrument responses that underlie a policy rule, but who also recognize that operating the rule requires judgment and can be done by computer. A policy rule need not necessarily mean either a fixed setting for the policy instruments or a mechanical formula."

Mr. Conti-Brown, is the Fed transparent about its objectives and actions for monetary policy? And should they, in fact, follow a fixed monetary policy rule?

Mr. CONTI-BROWN. So recognizing that I am a legal scholar and a historian, not an economist, let me answer that question, and that is actually not so much a qualifier, but gives insight into why I am not in favor of the House bill that is sometimes called "the Taylor rule bill" or the "policy rule bill," and the reason is that law can be very sticky. So Professor Taylor has been talking about how we just need—you know, define your rule, and if it deviates from the Taylor rule or whatever rule is specified by the House, then explain it. And in a perfect world where people come to these questions rationally, are looking at the same data and information, this becomes a very technocratic or technical evaluation. You can imagine that there would be built in a great deal of consensus about why a rule that was written in statute should be deviated from.

Now, as an expert in the Federal Reserve Act, I can tell you there are so many provisions that were written subject to political compromises of decades long past but still exert a great deal of pressure over the organization of our central bank. So the thing that I fear about a statutory policy rule is that it would just get stuck in statutory inertia and make it very difficult to deviate, even if there is broad consensus ideologically among economists and others that there should be that deviation. And, indeed, the periods historically that Professors Taylor and Meltzer have pointed to as being eras when there have been really successful outcomes, those were policy rules adopted internally by the Fed. The Fed today has also adopted policy rules and is very clear about what their outcomes and targets are at a time—more clear than they were, in fact, during that period that is pointed to as really the bastion of policy rules.

So that is what gives me great pause about putting policy rules into the Federal Reserve Act, is the unintended consequences that future generations will be dealing with a political moment that we are confronting today, where, frankly, there is not even consensus among economists as to the virtues of this action for today's problems, let alone tomorrow's.

Senator BROWN. Thank you. Let me for a moment ask you to discuss sort of the difference between transparency and clarity. No one has accused the Fed, at least in my lifetime, of always being clear in its public statements. President Fisher of the Dallas Fed delivered a speech and said, "In this era of social media and uber transparency, we all at the Fed need to learn to speak English rather than Fed-speak." It seems to me it would not take legislation. It would be more effective than Audit the Fed.

Give us briefly your thoughts on how the Feds could do more to change how they speak to the American public.

Mr. CONTI-BROWN. Absolutely, I think that that emphasis on clarity is extremely important. Chairman Greenspan very famously said in 1987, since he became Fed Chairman, he learned to "mumble with great incoherence," and that was seen as a bastion of an old guard rule that central bankers never defend, never explain.

That is changing, and it is continuing to change. The Fed can do more, by speaking in English, issuing FOMC statements that have clarity around them, having a Web site that is easy to navigate, which the Fed has done and markedly improved, having a more liberal FOIA policy where they let go of some of their documents. As a scholar, I have had some run-ins with the Fed where they have held onto things that they should not have held onto, other things they released that they should, and it is very healthy. So I think the Fed is paying a great deal of attention to its public-facing interactions. It is doing more, and Members of Congress should encourage it through hearings and through our mechanisms to say that they should stop speaking in too technical language.

The last point I would make on this, here is why the diversity on the FOMC and Board of Governors is so essential, and diversity here I mean in an intellectual and methodological approach. Academic economists have now dominated the FOMC, the Reserve Bank Presidents on the Board of Governors, and I think economists, of course, have a natural interest in the functions of the macro economy and the functions of central banks. But when they all gather together, they start to speak a language that is not necessarily accessible to the American people because the American people do not all have Ph.D.s in economics.

Having more people who are coming from legal backgrounds, banking backgrounds, consumer backgrounds, labor backgrounds, historians, others, to participate in not only the formulation of policy but also its explanation to others would go a very long way at reaching the clarity that you are talking about, Senator Brown.

Senator BROWN. Thank you. And the last question—and Dr. Meltzer told us, I thought very aptly, gave his description of regulatory capture with some thoughts on what to do. Give me yours.

Mr. CONTI-BROWN. So regulatory capture is sometimes defined as when the regulated get to dictate the terms to the regulators it is a problem all throughout our economy, not just in the financial sector. But it is hardwired into the Federal Reserve Act. The mechanisms that you described where it is not just Class B and C Directors who choose the Presidents. Class A Directors are still, just as you said, in the selection of the Directors, are they participating in those conversations? Are they putting forward names, even if they do not formally vote? We do not know. But the very idea that bank-

ers are selecting their regulators, not through Congress but directly, by the exercise of a vote, should give us all pause and ask questions about how could the Reserve Bank Presidents do anything but dance with the one that “brung” them. This is the problem that I see, and I think addressing those governance problems at the Reserve Banks would go a very long way at increasing public accountability, congressional oversight of the appointment personnel level in a very healthy way, and indeed could help facilitate rules-based monetary policy. If we want to see a Taylor rule at the Fed, then we should appoint Professor Taylor to be at the Fed, and having that kind of focus on appointment personnel—

Chairman SHELBY. That would probably be a great idea.

[Laughter.]

Chairman SHELBY. He has been mentioned. Maybe he will be.

Mr. CONTI-BROWN. I think that that would be vastly superior to writing the Taylor rule into the Federal Reserve Act, is focusing on the appointment and governance structure of the Fed instead of dictating policies.

Senator BROWN. Thank you, Mr. Chairman.

Chairman SHELBY. Dr. Taylor, your name has been mentioned here several times by me and others and by Mr. Conti-Brown, and the Taylor rule. Do you want to respond to any of that?

Mr. TAYLOR. Just briefly. There is nothing in the House bill where a rule would be written into statute, as I hear Mr. Conti-Brown saying. This is the Fed’s decision to choose its strategy and its rule. And as Allan Meltzer indicated, during certain periods it has done that quite well. In other periods it has not.

I think part of the accountability would be that they would say what they are doing and when they are off and when they are on, and there could be a good discussion of that. It seems to me it is so integral to public policy.

I think the idea that the Fed could just do it on its own—in other words, the Chair could come up and just describe the strategy and without any legal change—it is conceivable. But I think the partnership, if you like, the accountability, would benefit if it was actually part of the law. Many people have taken this suggestion, many people at the Fed said, well, we can do that anyway. But I think they are not. And so this would be, I think, an encouragement for them.

It is hard for me to understand why people object to this. Most of the objections—and, admittedly, I might not be hearing them properly. But most of the objections seem to be misinterpreting what the law, what the proposal, what the bill is all about. And just if I go back to Senator Brown’s question of Mr. Conti-Brown, there is a distinction between setting a goal, like 2-percent inflation, and setting your strategy to get to the goal. There is a difference. That is in some sense why I quoted from Janet Yellen. This is simply just meant to be someone who has thought about this for many years, and carefully. She said a rule could help the Federal Reserve communicate to the public the rationale behind its moves—that is, instrument moves—and how those moves are consistent with the objectives, like 2-percent inflation.

So there is a great deal of value to having a dialog like that. It is more than we have now. And I think going back to the experi-

ence, we have had periods where, as Allan Meltzer indicated, the policy has been more strategic, rule-like, less reacting to individual things, more understandable, more predictable, and the economy has worked better. And then there are these other periods, unfortunately—and I wish I could have been part of the answer to that 20-percent unemployment in Indiana. That just did not magically happen. That 20 percent was also due to public policy, going down to 5. But do not forget that we are trying to avoid those 20-percent phenomena. It is terrible.

And so, sincerely, from looking at the experience, the way Government works, my own experience in Government, it seems to me that there is a lot of ration off this. It does not need to be partisan. There is a lot of people who understood this and study it. So I urge you to continue talking about it, Mr. Chairman.

Chairman SHELBY. I thank the panel. We will continue our hearings regarding the Fed and other regulatory agencies. Thank you very much.

[Whereupon, at 4:25 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF JOHN B. TAYLOR

MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY

MARCH 3, 2015

Chairman Shelby, Ranking Member Brown, and other Members of the Committee, thank you for the opportunity to testify at this hearing on “Federal Reserve Accountability and Reform”.

In my opening remarks I would like to focus on a particular reform that would improve the accountability and transparency of monetary policy and lead to better economic performance. The reform would simply require the Fed to describe its strategy for monetary policy. It is a reform about which both Chairman Shelby and Chairman Jeb Hensarling of the House Financial Services Committee asked Fed Chair Janet Yellen in their opening questions at the Congressional hearings last week. It has attracted a lot of attention and has led to discussion and debate in the media, in the markets, and among economists.

The prime example of such a reform is a bill which passed out of the House Financial Services Committee as Section 2 of HR 5018 last year.¹ This bill would require that the Fed “describe the strategy or rule of the Federal Open Market Committee for the systematic quantitative adjustment” of its policy instruments. It would be the Fed’s job to choose the strategy and how to describe it. The Fed could change its strategy or deviate from it if circumstances called for a change, but the Fed would have to explain why.

In considering the merits of such a reform, I think it is important to emphasize the word “strategy” in the bill. Though monetary economists often use the word “rule” rather than strategy, the term rule can sometimes be intimidating if one imagines that a rules-based strategy must be purely mechanical, contrary to what I and others have argued for many years. The United States Congress through the Senate Banking Committee and the House Financial Services Committee is in a good position—and in a unique position in our Government—to oversee monetary policy in a strategic rather than a tactical sense. The most effective way to exercise this oversight is to require that the Federal Reserve describe its strategy publicly as the House bill does.

Experienced public officials know the importance of having a strategy and the close connection between a strategy and a rules-based process. One of the most experienced, George Shultz, put it this way, and I quote² “Let me explain why I think it is important, based on my own experience, to have a rules-based monetary policy. First of all, if you have policy rule, like a Taylor Rule, you have a strategy, which is sort of what it amounts to . . . And at least as I have observed from policy decisions over the years in various fields, if you have a strategy, you get somewhere. If you don’t have a strategy, you are just a tactician at large and it doesn’t add up. So a strategy is a key element in getting somewhere.”

Fed Chair Janet Yellen made similar observations when she served on the Federal Reserve Board in the 1990s. In “Monetary Policy: Goals and Strategy” she explained that³ “The existence of policy tradeoffs requires a strategy for managing them,” and she described a policy rule (the Taylor rule) pointing out “several desirable features” it has “as a general strategy for conducting monetary policy.” She also stated that “the framework of a Taylor-type rule could help the Federal Reserve communicate to the public the rationale behind policy moves, and how those moves are consistent with its objectives.”

In testimony before the House Financial Services Committee last summer I described how experience and research by many people over many years has shown that a rules-based monetary strategy leads to good economic performance.⁴ This view is based on historical and statistical evidence. During periods when policy is more rules-based as in much of the 1980s, 1990s, the economy has performed well.

John Brian Taylor is the Mary and Robert Raymond Professor of Economics at Stanford University, and the George P. Shultz Senior Fellow in Economics at Stanford University’s Hoover Institution.

¹For additional background on this general type of reform see John B. Taylor, “Legislating a Rule for Monetary Policy”, *The Cato Journal*, 31 (3), Fall, 407–415, 2011.

²“The Importance of Rules-Based Policy in Practice”, in *Frameworks for Central Banking in the Next Century*, Michael D. Bordo, William Dupor, and John B. Taylor (Eds.), A Special Issue on the Occasion of the Centennial of the Founding of the Federal Reserve, *Journal of Economic Dynamics and Control*, Volume 49, December 2014.

³Janet L. Yellen, “Monetary Policy: Goals and Strategy”, Remarks to the National Association of Business Economics, Washington, DC, March 13, 1996.

⁴For a summary of the research see John B. Taylor and John C. Williams “Simple and Robust Rules for Monetary Policy”, in Benjamin Friedman and Michael Woodford (Eds.), *Handbook of Monetary Economics*, Elsevier, 2011, 829–859.

During periods such as the 1970s and the past decade when policy has been more discretionary, economic performance has been poor. The shifts in policy preceded the shifts in economic performance, which indicates that policy shifts cause the changes in performance.

In a compendium published just last December to mark the Centennial of the Federal Reserve, Michael Bordo, Richard Clarida, John Cochrane, Marvin Goodfriend, Jeffrey Lacker, Allan Meltzer, Lee Ohanian, David Papell, Charles Plosser, and William Poole joined George Shultz in writing about the advantages of such a policy strategy.⁵ Most also agreed that during the past decade the Fed has either moved away from a rules-based strategy or has not been clear about what the strategy is. As stated last week by monetary economists Michael Belongia and Peter Ireland⁶ “For all the talk about ‘transparency,’ . . . the process—or rule—by which the FOMC intends to defend its 2-percent inflation target remains unknown.”

Hearings specifically about this reform and other hearings such as those with Chair Yellen last week have been useful for getting input and finding the best way forward. But concerns and misunderstandings persist. For example, in answering questions from Chairman Shelby last week, Fed Chair Yellen stated that “I am not a proponent of chaining the Federal Open Market Committee in its decision making to any rule whatsoever.” And the next day she repeated that view to Chairman Hensarling, saying “I don’t believe that the Fed should chain itself to any mechanical rule.” And in both hearings she quoted me saying that the Fed should not follow a mechanical rule. But the House monetary strategy bill, or similar proposals, would not chain the Fed to any rule. First, the Fed would choose and describe its own strategy, and it need not be a mechanical rule. Second, the Fed could change the strategy if the world changed, or it could deviate from the strategy in a crisis; so it would not be “chained.” The Fed would have to report the reasons for the changes or departures, but, as in the example of departing from the policy rule during the stock market break in 1987, which Chair Yellen referred to, it would not be difficult to explain such adjustments.

Another concern has been raised by those who warn that by publicly describing its policy strategy, the Fed would lose independence. In my view, based on my own experience in Government, the opposite is more likely. A clear public strategy helps prevent policymakers from bending to pressure. Moreover, *de jure* central bank independence alone has not prevented departures from a rules-based strategy. *De jure* central bank independence has been virtually unchanged in the past 50 years, yet policymakers have varied their adherence to rules-based policy. These variations demonstrate the need for legislation requiring the Fed to set and clarify its strategy for its policy instruments.

Some have expressed concern that a rules-based strategy would be too rigid. But the reform provides flexibility. It would allow the Fed to serve as lender of last resort or take appropriate actions in the event of a crisis. A policy strategy or rule does not require that any instrument of policy be fixed, but rather that it flexibly adjusts in a systematic and predictable way to economic developments. Moreover, as I indicated, the reform allows the Fed to change its rule or deviate from it.

Another concern is expressed by those who claim that the House monetary strategy bill would require the Fed to follow the Taylor Rule; but this is not the case. The bill does require the Fed to describe how its strategy or rule might differ from a “reference rule,” which happens to be the Taylor rule. However, describing the difference between a particular policy rule and this reference rule is a natural and routine task for the Fed. In fact, many at the Fed already make such comparisons including Fed Chair Yellen;⁷ another recent example is the Fed staff paper that makes extensive use of the rule to measure the impact of the Fed’s unconventional policies.⁸

It is important to point out that there is precedent for this type of Congressional oversight. Previous legislation, which appeared in the Federal Reserve Act from 1977 to 2000, required reporting of the ranges of the monetary aggregates. The legislation did not specify exactly what the numerical settings of these ranges should be, but the greater focus on the money and credit ranges were helpful in the disinflation efforts of the 1980s. When the requirement for reporting ranges for the

⁵ *Frameworks for Central Banking in the Next Century*, Michael D. Bordo, William Dupor, and John B. Taylor (Eds.), A Special Issue on the Occasion of the Centennial of the Founding of the Federal Reserve, *Journal of Economics Dynamics and Control*, Volume 49, December 2014.

⁶ Michael Belongia and Peter Ireland, “Don’t Audit the Fed, Restructure It”, *e21* February 19, 2015.

⁷ Janet Yellen, “The Economic Outlook and Monetary Policy”, *Money Marketeers*, New York, New York, April 11, 2012.

⁸ Eric Engen, Thomas Laubach, and David Reifschneider, “The Macroeconomic Effects of the Federal Reserve’s Unconventional Monetary Policies”, January 14, 2015.

monetary aggregates were removed from the law in 2000, nothing was put in its place. A legislative void was thus created concerning reporting requirements and accountability. In many ways reform is needed simply to fill that void.

In my view the Congress and this Committee now have an opportunity to move forward on such a reform in a nonpartisan way with constructive input from the Fed. The result would be a more effective monetary policy based on a strategy to achieve the goals of a better performing economy which we all share. I would be happy to answer any questions you may have about this reform or others.

PREPARED STATEMENT OF ALLAN H. MELTZER

THE ALLAN H. MELTZER UNIVERSITY PROFESSOR OF POLITICAL ECONOMY, TEPPER
SCHOOL OF BUSINESS, CARNEGIE MELLON UNIVERSITY

MARCH 3, 2015

What does “independent” mean when the Federal Reserve is called an independent agency? The question is not one that the Federal Reserve or others try to answer, so we must look at what it does to supplement its few efforts to define independence.

The answer is mixed. Any agency that can quadruple the size of its balance sheet without oversight over 4 or 5 years, as the Fed has just done, has considerable freedom or independence. Yet, many of the increased services, more than 40 percent, went to finance the outsized budget deficits during the period. Independent central banks do not finance budget deficits.

In fact, the original Federal Reserve Act in 1913, did not permit any Federal Reserve support of the Treasury. For the founders, an independent central bank followed a gold standard rule and also a rule that prohibited financing the Treasury and the budget. Those two rules supported an independent Federal Reserve during the 1920s. After surrendering independence to finance World War I and accepting control by the Treasury and administration in the early postwar, the Federal Reserve restored its independence by restoring the gold exchange standard. That standard was a weaker type of gold standard that became an operating rule. The Fed worked to expand the gold exchange standard internationally. The U.S. did not leave the standard until 1934, but it did not monetize gold inflows in 1930–32, a mistake but made independently.

The prohibition against financing the Treasury did not last long. By 1923, the Reserve Banks, subject to Board approval, bought and sold Treasury issues to change bank reserves. Once open market operations became the principal means of implementing monetary policy, the Federal Reserve could buy new Treasury issues, not directly from Treasury, but in the market.

Legally the Federal Reserve remained an independent agency. Once the two rules were no longer binding, independence lost much of its meaning. As Milton Friedman claimed (Friedman, 1959), and Thomas Cargill recently documented (Cargill, 2014), it is a rule that restricts Federal Reserve actions. And it is the decision to follow a rule that maintains central bank independence.

In the 1930s, once the two original rules no longer affected Federal Reserve decisions, the Treasury demanded monetary actions. Secretary Morgenthau wanted low interest rates to finance budget deficits. He threatened to use the profit from revaluing the gold stock to purchase debt, if the Federal Reserve allowed interest rates to rise. Legal independence gave no protection.¹

As is well-known, the Federal Reserve agreed to hold interest rates fixed to finance World War II debt. The Federal Reserve sacrificed its independence. The Korean War is the only war in which the Federal Government ran a budget surplus in the war years 1951–52.

The Federal Reserve used concern about Korean wartime inflation to end its policy of pegging rates inherited from World War II. From the end of the war in 1945 to March 1951, the prevailing Federal Reserve position was that it could not regain independence because it lacked political strength. The Federal Reserve acted only after several U.S. senators led by Senator Paul Douglas insisted on an end to the wartime pegging policy. The Fed’s independence remained restricted by its agreement to maintain an “even keel” when the Treasury issued debt, so independence of Treasury was not complete. Even keel required the Federal Reserve to support Treasury issues by purchasing treasuries if a treasury issue was mispriced. The Fed

¹ More detail on this period and other examples of lack of independence that I cite, and some that I don’t cite, come from my Federal Reserve history.

continued even keel interventions until the 1970s when the Treasury finally decided to auction its bonds and notes.

A much greater restriction on independence after 1951 was Chairman Martin's definition of independence, borrowed from an earlier statement by Alan Sproul of the New York bank. This is the only explicit definition offered by officials. Martin said that the Fed was independent within the Government, not independent of the Government.

Martin explained the distinction on several occasions. Independence within Government turned out to have little true independence. Martin explained that if Congress passes and the president signs a budget that requires substantial deficit finance, the Federal Reserve has the obligation to help finance the budget. A consequence of this policy was that inflation remained lower than the 1.4 percent average of consumer price inflation in the 1950s, when President Eisenhower maintained small deficits or surpluses except in the recession year, 1958. In the years of President Johnson's larger Federal budget deficits, 1965–69, the average inflation (CPI) rate rose to 3.5 percent and was rising at a 5.5 percent rate when Martin retired.

Arthur Burns replaced Martin. Burns was a frequent visitor at the White House and considered himself a friend and confidant of President Nixon. During his term as chairman, CPI inflation averaged 6.6 percent and reached as high as 11 percent in 1974. Burns was present with Administration officials when President Nixon adopted price and wage controls in 1971. As part of the controls program, Burns chaired the Committee on Interest and Dividends. He cannot be regarded as independent during President Nixon's terms.

The Carter administration did not reappoint Burns to a third 4-year term as chairman because he did not share information with them. This was a more independent Burns. His replacement was a businessman who had worked in the Carter presidential campaign and served on a regional Federal Reserve Bank board. The choice shows no evidence of a desire for an independent monetary policy.

When President Carter moved William Miller to Treasury Secretary, he appointed Paul Volcker as Federal Reserve chairman. Volcker was a relatively independent chairman committed to a policy of reducing inflation. President Carter shared his aim. He did not share Volcker's belief that the Federal Reserve had to reduce money growth to lower inflation. President Carter under pressure from Congressional members of his own party, chose to have the Federal Reserve impose credit controls. Volcker participated in the Administration discussions and agreed to implement the control program. This is a breach in his independence.

The Federal Reserve credit control program was rather benign. The public's reaction much less so. A widespread surge of popular support for lower inflation brought a large decline in spending and quarterly GNP. Although use of credit cards was not restricted, thousands mailed their credit cards to the White House and the Fed.

The response to credit controls was so strong that the open market committee shifted to expansive policy in the summer of 1980. Credit controls ended.

In the fall of 1980, the Federal Reserve raised interest rates and renewed anti-inflation policy. President Carter accepted the Fed's actions. He declined to act despite the urgings of his advisers who warned that high unemployment and high interest rates would hurt his campaign for reelection. Volcker was not pressed to lower interest rates.

Ronald Reagan won the 1980 election. His campaign promised to reduce inflation. Despite urgings from the so-called supply-side economists at the Treasury, President Reagan did not pressure the Federal Reserve. The president accepted the highest unemployment rate of the postwar years, 10.8 percent, and with it the loss of many Republican seats in the fall 1982 election.

Volcker called himself a "practical monetarist." He explained repeatedly what I call the anti-Phillips curve foundation of his strategy. He often told Congress and the public that the way to reduce the unemployment rate was to lower expected inflation. Despite long term interest rates of 5 to 7 percent, the economy recovered strongly in 1983 and 1984. Inflation remained low most years after 1984.

Alan Greenspan replaced Volcker in 1986. Greenspan further lowered the inflation rate. He was also a relatively independent chairman who resisted open criticism from the Administration of his anti-inflation policy during the 1992 election year.

Greenspan made a radical departure from the discretionary policy followed by many of his predecessors. From 1986 to about 2002, he let the Fed more or less follow a Taylor rule. This produced a long period of growth, short and mild recessions, accompanied by low inflation. After the fact, the period was called "the great moderation" because of the combination of relatively stable growth, low inflation, and short, mild recessions.

By following a rule, the Greenspan Fed produced the longest period of stable growth and low inflation in Federal Reserve history. Greenspan was able to maintain Federal Reserve independence because his policy maintained popular support. Following a rule sustained a rule sustained independence.

There are many explanations of the so-called great moderation. I believe the main reason is reliance on the Taylor rule to guide policy. Following that rule induces policymakers to avoid responding to noisy monthly and quarterly data. By following a Phillips Curve, FOMC actions increase variability. The Fed responds to the unemployment rate and ignores inflation until inflation rises. Then it ignores unemployment until unemployment rises. By approximately following a Taylor rule, the Federal Reserve responded to both unemployment and inflation. That gave more of a medium-term focus to their actions and avoided shifting from one goal in the dual mandate to the other.

Unfortunately, the Greenspan Federal Reserve reverted to earlier procedures after 2003. And when Ben Bernanke became chairman in 2006, the Fed restored its policy of responding to noisy, frequently revised monthly reports on unemployment.

The Bernanke Fed made the mistake of bailing out a failed Bear Stearns early in 2008. This contributed to the belief that the Fed would support failing financial firms. By encouraging this belief and doing little to force banks to strengthen their balance sheets and increase equity reserves, the Fed encouraged the financial system to be unprepared for the crisis that followed failure of Lehman Brothers in October 2008. Bankers interpreted Federal Reserve policy statements as an indication that it would bail out large banks. Lehman's failure came when the financial system was undercapitalized. Fear of additional failures—widespread collapse of the payments system—was met by massive Federal Reserve action including a bailout of a major insurance company.

The Treasury and the Federal Reserve worked together to restore confidence and solvency. There was no thought of independence. In a major crisis independence vanishes. This was true of the Bank of England under the traditional gold standard, and it remains true.

Preventing systemic collapse avoided the mistakes of 1929–32. Although some at the Fed claimed to follow Bagehot's (1873) rule, that is only partly true. The Fed lent freely to all legitimate borrowers, but it did not charge a penalty rate to limit lending to those at risk. Most importantly, in its 100 year history it never announced a rule for the lender of last resort. Bagehot understood that announcing the crisis rule encouraged banks to hold short-term paper eligible for discount.²

Following its successful policy of preventing financial collapse, the Federal Reserve pursued the most expansive policy in its history. Idle excess reserves of banks rose from less than \$800 billion to more than \$2.5 trillion. Currently, on its projected path, idle reserves will reach \$3 trillion in 2014.

This policy finances massive Government budget deficits at very low interest rates. This is the very opposite of what an independent central bank does. I do not know of any example, anywhere, in which base money creation to finance large budget deficits avoided higher inflation. The Federal Reserve has not revealed a credible policy that will prevent future inflation.

Market participants credit the Federal Reserve with ability to prevent inflation. That seems to neglect much previous history. Perhaps market expectations are encouraged by the low inflation to date. That ignores the possible tsunami of idle reserves that spill over the domestic and international economy.

What We Should Learn

In its first 100 years, the cpi inflation rate rose from 1 percent in 1914 to 18 percent during World War I, then fell to -10.5 percent in 1926. Under the gold exchange rule from 1923 to 1929 inflation remained relatively low and stable, never exceeding 2.3 percent in 1925.

During the 1930s, inflation fell to -9.9 percent in 1932 and rose to 3.6 percent during the inflation scare of the mid-1930s. Price and wage controls held down reported inflation rates during World War II. Nevertheless, cpi inflation reached 10.9 percent in 1942 and 14.1 percent in 1947 after the Congress removed controls.

² Bagehot criticized the Bank of England for not publicly announcing its lender-of-last-resort policy. In its entire history, the Federal Reserve has never announced a crisis policy. By announcing its policy, the Federal Reserve would encourage some banks to act prudently. For more detail on Federal Reserve lender-of-last-resort policy see Goodfriend (2012, 2013) where he relates the Federal Reserve failure to the incentives induced by its governance structure. See also Bordo (2014) at this conference.

By the late 1960s and the 1970s, inflation rose as the Federal Reserve helped to finance Federal budget deficits. That ended with the Volcker disinflation and the Greenspan policy.

Table 1 shows a rough measure of recent Federal Reserve independence, the portion of a relatively large budget deficit financed by issuing base money. This measure is not useful for periods like the 1950s, when the budget deficit was small in most years and budget surpluses were frequent.

The chart shows the large difference between the Volcker years and the Bernanke years. President Obama's deficits increased massively, and the Federal Reserve financed a much larger share. The inflation consequences are currently postponed because banks hold most of the reserves idle. Independent central banks behave like the Volcker Fed, not like the Bernanke Fed.

Table 1
Base Money Finance of Budget Deficits

Period	Cumulative Change in Base	Cumulative Deficit	Percentage Col. 2/Col. 3%
	Billions	Billions	
(1)	(2)	(3)	(4)
Volcker			
1979/8 – 1987/8	\$115.3	-\$1251.2	9.2
Greenspan			
1987/8 – 2006/1	589.4	-2795.2	21.1
Bernanke			
2006/2-2013/2	2901.1	-6685.9	43.4

The Bernanke Federal Reserve never claimed to hold interest rates low to help the Treasury and it did not repeat Chairman Martin's definition of independence. It defended its policy as an effort to lower the unemployment rate. With trillions of idle reserves on bank balance sheets and additional trillions of money and short-term securities on corporate balance sheets, it did not explain what it thought additional reserves could achieve that could not be achieved by the banks and corporations. This seems an elementary error, but an error nonetheless. I believe it is a political decision made by a politicized and therefore nonindependent Federal Reserve.

A main lesson of this trip through history is that following a rule or quasi-rule in 1923–28 and 1986–2002 produced two of the best periods in Federal Reserve history. The lesson I draw, as Friedman (1959) taught us, following a rule contributes to independence by producing better outcomes, but claiming independence does not.

No rule will work perfectly in all circumstances. The classical gold standard rule required suspensions during crises. Following a Taylor rule produced better than average results. Congress, under Article I, Section 8 of the Constitution, should require the Federal Reserve to follow a specific Taylor rule with opportunity to deviate based on an announced objective.

The Federal Reserve is an agent of Congress. Congress holds a hearing twice a year to fulfill its oversight requirement. Federal Reserve chairmen are able to avoid serious oversight because they are able to talk around their mistakes. A rule would increase control by Congressional oversight committees.

A Taylor rule can improve monetary policy and economic performance. It achieves greater policy independence also. It should be supplemented by a pre-announced rule for its service as lender of last resort.

Bibliography

- Bagehot, Walter, (1873/1962). *Lombard Street*. Homewood, IL: Richard D. Irwin.
- Bordo, Michael, (2014). "Rules for a Lender of Last Resort: An Historical Perspective". Xeroxed, Rutgers University, April.
- Friedman, Milton, (1959). *A Program for Monetary Stability*. New York: Fordham University Press.
- Cargill, Thomas, (2014). "Independence No Substitute for Rules Board Policy", *Central Banking*, 24 (February), 3, 9–46.
- Goodfriend, Marvin, (2012). "The Elusive Promise of Independent Central Banking". *Money and Economic Studies*, Bank of Japan, November, 39–53.
- Goodfriend, Marvin, (2013). "Lessons Learned From a Century of Federal Reserve Lending". Testimony Subcommittee on Monetary Policy and Trade, House Committee on Financial Services, September 28.

Recent Major Fed Errors and Better Alternatives

By Allan H. Meltzer*

am05@andrew.cmu.edu

Carnegie Mellon University and
The Hoover Institution

USA

Abstract

This paper discusses a central issue about the recent slow recovery. Why did enormous, unprecedented monetary stimulus have such a small response? The Fed made three major errors. It failed to recognize that the principal economic problems were real, not monetary. It focused excessively on short-term data, and failed to develop a useful strategy. And it ignored changes in money and credit. The Obama administration caused the principal real problems by imposing costly regulation, and an approach to business that the Economist called "The Criminalization of American Business."

Keywords:

Monetary policy, Federal reserve, Policy errors, Banking system

"Here, then the rulers of society have an opportunity of showing their wisdom—or folly. Monetary history reveals the fact that folly has frequently been paramount; for it describes many fateful mistakes." Knut Wicksell

Wicksell was far ahead of me in recognizing folly, but his message remains appropriate. I will mainly discuss policy folly. Since the paper criticizes the decisions and actions of the Federal Reserve let me be clear from the start that my criticisms are not personal. I do not question that the actions were taken out of mistaken beliefs and a willingness to ignore evidence, not out of malice or ill will. It is the ideas and their applications, not the people that are at issue.

* I am indebted to Marvin Goodfriend and Mickey Levy for extensive comments. This is a slightly revised version of a paper presented at the 2014 Federal Reserve Bank of Chicago conference that they declined to publish in the conference volume.

Despite an accumulation of idle reserves in the financial system amounting to more than \$2.5 trillion dollars, the Federal Reserve has continued to add reserves. The chair and a majority of the open market committee claim that they act to reduce unemployment and possible deflation. I claim below that these actions compound several errors.

Alas, they are not the only errors. The open market committee overemphasizes information in very short period data—monthly and quarterly data—and gives insufficient attention to information about persistent trends. This is especially true of the neglect of growth of money and credit. It is hard to understand how a central bank can largely ignore growth of the principal aggregates that it supplies.

Also, the Board staff and principals made no visible effort to prevent the financial crisis in 2008, and we now learn that staff at the New York Federal Reserve Bank believed that Lehman Brothers was solvent and could have been supported.¹ This is directly contrary to repeated statements by the New York Fed President Geithner and Board Chairman Bernanke. In the months preceding the crises, the Federal Reserve took no actions to prevent the calamity, mainly, because it denied that a general problem would occur. But it added to the crisis in several ways including approving undercapitalized subsidiaries that held mortgage backed securities but had little equity. And it allowed major banks to reduce required equity by holding bonds that they insured. Such actions greatly reduced the cost of risk to the banks with little equity.

The result was Congressional action that granted additional power and authority. Instead of approving the Brown-Vitter bill that would require a substantial increase in equity capital, Congress increased the rules applied to major banks. Eventually, the Board raised required equity capital, but not enough to impose strong incentives for prudence on major bankers and their principal stockholders.

The Board and the Reserve Banks employ many able professional economists. Surely there are some that remind their principals that managers and principal stockholders have much stronger incentives than regulators to prevent losses that they bear. Regulators especially in New York are likely to be “captured” by major banks and reluctant to act against them. How else can we explain the excessive payments to Goldman Sachs and others when AIG failed?

Stewart, James B. and Eavis, Peter (2014). “Revisiting the Lehman Brothers Bailout That Never Was,” *New York Times*, September 30, A1.

These examples introduce some of the main reasons for Federal Reserve errors, failures, and misjudgments. That said, I must add that I applaud the extreme action taken in 2008 to prevent financial collapse. That was a major effort, and it succeeded.

The rest of this paper analyzes some of the errors. A later section proposes changes that would improve policy operations and the outcome under which we all live. No one will be surprised that some of the proposals call for rule-like actions.

Policy Errors

As an historian, I am very aware that the 1913 Federal Reserve Act imposed restrictions—rules—on what the new agency could do. First, it applied the gold standard rule that an earlier Congress (1900) wrote into law. And the 1913 Congress imposed a second rule—absolutely no direct support for the Treasury by making loans to the Treasury.² Under that rule, it did not buy Treasury bonds. To finance World War I the Fed circumvented the restriction by making low cost loans to banks that purchased the bonds.

By the early 1920s, the Federal Reserve learned to circumvent the second rule more directly. It bought Treasury securities in the market. It could buy a new issue as soon as it came to market without violating the rule against direct purchase. Through most of its one hundred year history, it limited its purchases to short-term securities except during World War 2 and prior to the 1951 Accord. But it has abandoned any restraint on its purchases. It now holds several trillion dollars of Treasuries, and it has no coherent plan for reducing its balance sheet.

Goodfriend (2014)³ analyzes recent policy as a carry trade. The Fed borrows at the short-end and lends at the long-end. By doing so, it takes on balance sheet risk when interest rates rise. The Fed will have to reduce its payments to the Treasury, recently near \$100 billion annually, when short-term rates rise above long-rates and capital losses increase.⁴

I praise the 2008 policy known as QE1. It prevented the collapse of the payments system by inducing expectations that banks would not fail because the Fed would work to flood markets

² This rule was later relaxed to provide limited temporary assistance. Garbade, Kenneth D., (2014) "Direct Purchases of U.S. Treasury Securities by Federal Reserve Bank," Federal Reserve Bank of N.Y., Aug. Garbade reviews the history of direct support by the Federal Reserve to the Treasury. Virtually all such direct financing was for very short periods, limited amounts, and in exchange for short-term debt.

³ Goodfriend, Marvin (2014). "Monetary Policy as a Carry Trade," unpublished, August.

⁴ To avoid recognizing losses, the Fed does not plan to mark bonds to market by holding them to maturity.

with liquid assets to stop heightened fears of bank insolvency. What of QE2 and QE3? The threat had faded. I will share why I believe they were a mistake, compounded by other mistakes.

The biggest mistake was to conclude that the slow recovery of employment and output was a monetary problem. Much evidence suggests that, after the initial collapse, the policy problem was real, not monetary. The Fed's big mistake was failure to see that most, possibly all, of the sluggish recovery resulted from real pressures on activity, especially business investment.

After a few years of the start of the massive expansions known as QE2 and QE3, someone at the Board or its staff should have recognized that despite massive stimulus, the economic expansion was the slowest recovery of the entire postwar period. As late as 2013, Census Bureau data show median household incomes 8 percent below the previous peak, from above \$56,000 in 2007 to below \$52,000 in 2013. And only 10 million jobs had been created in the recovery. This is a dismal performance, much discussed in the media. Why did it not lead to a re-examination of the Fed's policy and administration policy? This is a clear failure that should have led to re-examination and different policies.

In a 1969 paper, James Tobin⁵ developed a model of monetary transmission in which the relative price of existing assets plays a major role. In the many models, I analyzed with Karl Brunner,⁶ the same is true. The transmission of monetary policy affects asset prices such as prices of capital assets and real estate. The rise in the nominal asset price is also an increase in the price of existing capital relative to the replacement cost of new capital. Current investment rises following a rise in the asset price of capital and builders construct new housing and apartments. Investment, economic activity and employment rise. When monetary policy tightens, the opposite occurs. Prices of capital assets fall reducing the price of existing capital relative to new production of assets. These models show how monetary expansion changes real variables.

There is more to the transmission process in our papers, but it should be obvious that the process just described is a dominant feature of a monetary cycle. It is no less obvious that it was incomplete in this cycle. Nominal prices of existing capital market assets rose spectacularly, but investment in new capital lagged and remained sluggish.

⁵ Tobin, James (1969). "A General Equilibrium Approach to Monetary Theory," *Journal of Money, Credit and Banking*, 1, February, 15-29.

⁶ Brunner, Karl and Meltzer, Allan H., (1968). "Liquidity Traps for Money, Bank Credit and Interest Rates," (1968) *Journal of Political Economy*, Jan., 1-38 and "Money, Debt, and Economic Activity," (1972). *Journal of Political Economy*, September.

That was a signal that the monetary transmission process was not working as it should. The Fed's error was to rely on less reliable models like the Phillips Curve or the Woodford models that ignore or severely limit the role of money, credit, and relative prices.

No less an authority than Paul Volcker explained publicly and to the staff that the Phillips Curve was unreliable and not useful. As Chair, he gave many talks about what I have called the anti-Phillips Curve. Volcker claimed repeatedly that the best way to reduce unemployment was to reduce expected inflation. He did not use Phillips Curve forecasts. He ran a very successful policy.

Alan Greenspan was less outspoken, but he also rejected Phillips Curve forecasts as unreliable. Instead of finding a better model, the staff resumed use of Phillips Curve forecasts. They were again unreliable as should be evident from the repeated prediction errors for quarterly or annual recovery. Year after year, growth and employment are below forecast.

One might hope that repeated forecast errors all in the same direction would raise doubts about the usefulness of the model or models and initiate search for a better model. This does not appear to have happened.

There are other signs that should concern economists and policymakers. I will mention two, or perhaps one and a half.

First, market data show that instead of investing in new capital, many firms are repurchasing shares after recent share price increases. Doesn't this strongly suggest pessimism about the future? Why ignore this signal?

Second, for years older men, 55 and above, have dropped out of the labor force. In this recovery, they have been joined by younger workers, 18 to 34. I count this as a possible additional sign of pessimism about opportunities, but it also reflects the increased unemployment compensation, health, food stamps and other benefits available to untrained workers. Many of them have taken the benefits and periodically work in the underground economy. It would be useful to study the degree to which the welfare state encourages this behavior.

The reduction in labor force, like the implications of low investment among other reasons for a sluggish recovery, should point us to real problems that monetary policy cannot affect. Below, I will explore some of the real problems affecting our economy. For the present, let me emphasize that the Federal Reserve mistakenly used low interest rates and huge increases in

reserves in an attempt to solve problems that were mainly not monetary. This was not just an error. I call it a series of blunders because it was repeated persistently.⁷

Didn't anyone question why reserves were piling up on bank balance sheets? Didn't anyone ask what more reserves could do that lenders could not do by using the existing reserves? Chair Yellen expresses concern about the number of part-time workers. Doesn't she recognize that the Affordable Care Act gives strong incentives to employers to avoid mandatory healthcare costs by hiring part-time workers. This is a nonmonetary explanation especially relevant for retailing and food service businesses. And, of continuing interest, shouldn't the System announce a workable, contingent strategy for reducing the more than \$2.5 trillion of reserves. Failure to do so suggests the absence of a reliable strategy consistent with the overemphasis on near-term and neglect of longer-term events and actions.

Month after month the Fed focused its attention and the market's concern for the noisy monthly reported jobs growth survey. It soon became clear that the initial announcement could be revised substantially the following month. Announcements that seemed to show that employment growth had returned were often followed a month later by revisions suggesting the opposite. And, at times, the opposite occurred; slow growth of employment could become better next month. Many of the market participants, like sheep, followed where the Fed led. Neither they, nor the Fed, publicly questioned the use of such a misleading indicator while neglecting the more persistent decline in labor force participation.

When the Fed finally stopped using monthly employment growth as a principal policy indicator, it later shifted toward several other labor market variables, especially the wage rate. Does the Fed have a reliable model of real wages? Shouldn't they make it available if they do?

Can monetary policy affect real wages? Has monetary neutrality been forgotten or lost? Or is this another error?

The 1913 Act barred the Federal Reserve from purchasing government securities. That prohibition did not last, but as late as the 1950s Chairman Martin and his colleagues defended a

⁷ At times, the rationale included preventing deflation—a decline in a general index of prices. QE1 may have prevented deflation. The case is weaker for QE2 and disappears by the time of QE3. Even if one accepts a risk of deflation, how can hundreds of millions of dollars of excess reserves prevent deflation? Renewed concern about deflation in 2014 repeats an old error, mistaking a large change in the relative price of oil as a change in the general price level. This repeats the error in the 1970s when oil prices rose. The Shadow Open Market Committee pointed out the error in 1975; The Federal Reserve recognized its error in 2000.

policy called “bills only” to keep the System from intervening in long-term markets. President Plosser and some others have urged a return to that policy or something similar.

On October 1, 2014, the open market account held the following longer-term issues:

Treasury Notes and Bonds	\$2.3 trillion
Agency Mortgage Backed Securities	1.7 trillion
Total Account Holdings	4.2 trillion

95 percent of the System holdings were at medium- to longer-term. This is a clear violation of prudent policy.

At the October 2014 FOMC meeting, President Lacker, (Richmond) dissented from the decision not to sell mortgage backed securities. He recognized and acknowledged that the Fed had made the serious error of engaging in credit allocation by buying mortgage backed securities and should try to return to a more neutral policy. President Lacker also objected to the use of monetary action to finance Treasury fiscal operations. Some of the press asked me to comment.

I wrote the following:

“President Lacker is right. Since 2008 the Federal Reserve has ignored the distinction between fiscal and monetary policy. It engages in fiscal policy in several ways. One is the way President Lacker highlighted. The Fed buys a very large share of the mortgages that come to the market. This is credit allocation and fiscal policy. No previous Federal Reserve engaged in such operations, although at times the Fed bought a few mortgages.

“That’s just one failing. The QE policy finances a large part of the budget deficit, and the enormous Fed holdings of government securities pay interest to the Fed. The Fed pays much of the interest to the Treasury, so a large part of the Fed’s earnings go to finance the budget deficit. This, too, is a fiscal operation.

“Further, the Dodd-Frank Act put the Fed fully into credit allocation to “disadvantaged” folk. This is a replacement for government spending. It is fiscal policy financed by the monetary authority. Why did Chairman Bernanke not object? Why doesn’t the Fed demand an end to the policy?

"One expects to see policies of this kind in badly run poor countries. Mature, developed countries usually refrain from such actions. The Fed is acting like the bad examples one used to find in Africa or Latin America. In the past, the Fed and others cautioned central banks not to engage in such practices. Who will caution us? Who will stop us from folly?"

"Finally, the Fed fails to recognize why their massive monetary expansion and sustained zero interest rate has had little impact on unemployment. The employment problem in the US is mainly a real economic problem that is out of reach for monetary expansion."

Another Fed error, highlighted by President Lacker's dissent is the use of monetary policy for credit allocation. Mortgage market operations are now dominated by official purchases. A once vibrant market no longer exists. This is one type of credit operation discussed in Goodfriend (2014),⁸ referred to earlier.

But it is not the only example of this error. Why did the Federal Reserve acquiesce without a public protest in the provision of the Dodd-Frank Act creating a credit agency called the Bureau of Consumer Financial Protection (BCFP)? Federal Reserve earnings finance this credit allocation but the Federal Reserve does not control the allocation. The new agency allocates credit to allegedly "disadvantaged" borrowers. This puts the Federal Reserve fully into the financing of political operations, without control of the choices. And it violates the provision of the United States constitution that requires Congress to appropriate all monies. The new law circumvents the constitutional requirement and opens the way to political allocation.

My reading of Federal Reserve history leads to a belief that no previous Board would have accepted this mandate to finance credit allocation. I believe BCFP reflects current inability by Congress to approve new spending programs, so they used credit allocation instead. This is a political act that sacrifices Federal Reserve independence. It further politicizes the Fed. It should be repealed promptly.

Why So Many Errors?

⁸ Goodfriend, Marvin (2014). "Lessons from a Century of Fed Policy: Why Monetary and Credit Policies Need Rules and Boundaries," *Journal of Dynamics and Control*, in press.

Many of the errors I have discussed have a common source: the Fed gives excessive attention to very short-term data, monthly and quarterly data. As a result, it lacks a strategy for achieving long-term stability of output, employment and the price level. I understand and appreciate the pressures from members of Congress, the administration, large parts of business, especially stock exchange traders, labor and others. One reason for independence is to permit Fed officials to reject these pressures. Unfortunately many of the officials share this short-term orientation. Some have told me that even if almost all the unemployment problem is real, not monetary, the Fed should work to reduce the small part that yields to their efforts. And what of the longer-term consequences of expanding reserves to do that? Manage them when they appear. That's the opposite of a strategy to stabilize the economy.

The original Federal Reserve Act, as I noted at the start, relied on rules—the gold standard especially. In several papers, I have pointed out that the two periods in the last 100 years in which the Fed came closest to providing stable growth and low inflation are 1923-28 and 1986-2002. In both, the Fed more or less followed a rule, the gold exchange standard for 1923-28 and the Taylor rule from 1986 to 2002. In both periods, recessions were mild and short-lived. Discretionary policy never did as well. The closest it came was 1953-60, but that period had deeper and more frequent recessions.

Rules bring several advantages. They focus policymaker's attention on medium or long-term objectives. When they are successful, as they have been, they reduce outside pressures. Good policy protects the Fed. During the years of moderation under Chairman Greenspan, Fed policy received less attention than it has in the current recovery. That increased stability.

Rules give market participants useful information about expected future policy actions. This reduces variability. The period when policy more or less followed the Taylor rule is consequently known as the years of "great moderation," because variability declined. By approximating the Taylor rule, the Federal Reserve avoided its usual mistake of shifting from one part of the dual mandate to the other. Instead it aimed at both. That increased stability.

The U.S. constitution gives Congress responsibility for money in Article 1, Section 8. The Federal Reserve Act makes the Federal Reserve the agent, but Congress retains nominal responsibility.

Congress has difficulty supervising its agent. Any person qualified to chair the open market committee can avoid formal criticisms from the House or Senate committees on

monetary policy. A rule would improve oversight by giving Congress a clear standard. The House of Representatives approved a rule in 2014. It represents a start on improved policy. I believe the current, proposed rule requires too much monitoring. Its strength lies in its setting a standard—the Taylor rule—but allowing the Federal Reserve to adopt any rule it wishes. It must adopt one and explain why it does not do as well as the Taylor rule, if that occurs.

By focusing policy on longer-term objectives, a policy rule helps the Fed to achieve stability. Discretionary policy has become overly dependent on quarterly forecasts. It should not surprise anyone to be told that economics is not the science that gives accurate quarterly forecasts. There is no such science. Monthly and quarterly data have large random components. The future is always uncertain in Frank Knight's or Keynes's definitions of uncertainty.

Some argue that the Phillips Curve is the only model of real activity and inflation that economists have developed. As noted earlier, that is a false statement. The Tobin and Brunner-Meltzer models allow money growth to have temporary real effects. In several papers Professors Stock and Watson have shown that the Phillips Curve is not a reliable model of real behavior. I claim that there is no persistently reliable model of quarterly activity. The proper response to this uncertainty is to adopt a somewhat longer horizon. At annual frequency money demand is much more stable than at quarterly frequency.

Prudential Policy

The Federal Reserve came into being in part to avoid or mitigate the financial market crises that culminated in the 1907-08 financial stringency. Its history since has been marked by deep crises. Clearly, the stability of the financial system has not increased. Some would argue that it deteriorated.

The earliest regulation to induce banks to adhere to a prudential standard is named for Walter Bagehot, editor of the *Economist* magazine. Bagehot's rule called on the central bank to "lend freely at a penalty rate." To do so, the Bank of England had to get government permission to suspend the gold standard. Bagehot recognized that in periods of financial panic, the Bank eventually asked the government to suspend the gold standard and then lent freely at a penalty rate.

I have called Bagehot an early rational expectationist because his call for a policy announcement told bankers in advance what policy to expect, thereby permitting them to adjust

their actions. The Federal Reserve has at times discussed a choice of policy, but it has never announced the crisis actions it would take. Bankers were not given information on which to form dependable expectations and incentives to guide their preparations.

Bagehot's rule did more. By calling for a penalty rate, it avoided banks using the offer of reserves as a way to borrow cheaply, as PNC Bank and perhaps others did in 2008-9. And by requiring banks to borrow against "good collateral," Bagehot's rule gave strong incentives to hold such collateral. That's another reason why the rule should be announced in advance and followed.

The original purpose of so-called prudential policy, better described as lender-of-last-resort policy, was prevention of bank runs and financial market collapse. Over time, the objective became the prevention of failures by very large banks. Over time, bailouts came to dominate policy. Small and medium-sized banks were allowed to fail; deposit insurance, paid by banks, compensated deposit holders. The public benefit was the spread of deposit banking by shifting risk from depositors to banks.

The Dodd-Frank Act substantially increased the authority and responsibility of the Federal Reserve and other banking agencies for policy in financial crises. The act claimed it avoided bailout of large banks. In fact, it gave final responsibility for bailouts to the Secretary of the Treasury, the very same officer that authorized all previous bailouts.

The Federal Reserve made the mistake of accepting responsibility for writing rules to increase financial stability. Some among them should know that the Federal Reserve had failed to require prudential policy in the years preceding the 2008 crisis. It permitted giant banks to create undercapitalized subsidiaries that acquired mortgages. Like the bankers, it failed to question the AAA rating given to many mortgage securities that subsequently went into default. The Federal Reserve banks sent numerous examiners to major banks prior to the crisis. They closely observed portfolio acquisitions. In a public forum, a chief examiner reported that the examiners did not question any of the transactions.

A former employee of the New York bank claims that the regulators are overly influenced by the large banks and reluctant to regulate them. Although the president of the New York Fed denies the charge, Federal Reserve's failure to act prudentially before the crisis seems consistent with the charge.

The reason is the standard problem of incentives. At best, regulators incentives are mixed. Capture is real and seems to be present.

On four occasions testifying in hearings leading up to Dodd-Frank, I urged Congress to require greatly increased capital requirements that applied to the largest banks without exception or risk weights. My analysis of the much less regulated banking system in 1929-1932 showed that none of the largest New York banks failed. All held at least 15 percent equity capital. Their policies were prudent. I argued that a return to a 15 percent equity capital requirement would restore safety and soundness. Principal stockholders would force management to lend prudently.

Senator Vitter (Louisiana) picked up my idea and developed the Brown-Vitter bill with Senator Brown (Ohio). This bi-partisan bill cannot get out of the Senate Banking Committee because of strong opposition by the large banks. Some of these banks seem to prefer the present system of detailed regulation combined with too-big-to-fail. One reason is that the market has given the largest banks a competitive advantage. They borrow at a lower rate than others. Former competitors that were not considered too-big-to-fail have disappeared. Several sold out to the largest banks—J.P. Morgan Chase, Bank of America, and Wells Fargo. Loan concentration increased dramatically. The Federal Reserve presided over this reduction in competition brought on by its policy of too-big-to-fail.

One consequence of current capital standards shows the problem. Prior to the crisis in 2008, some of the largest banks reduced their equity capital by substituting prime debt. Then they insured the debt with agents like AIG. If these banks made risky loans, others—not their owners—bore the loss. This is another bad example of regulation by regulators who have little incentive to oppose bank management and much greater incentive to get along by going along.

We will not develop a safer financial system without creating and enforcing standards that provide incentives for prudent policies. Thomas Hoenig, Vice Chairman of the FDIC shows how permitting banks to use risk weights lowers effective capital standards. His paper shows that Basel III capital standards are substantially lowered by permitting risk adjustment.⁹

Reforming the Federal Reserve

Two main parts of Federal Reserve operations are regulation policy and monetary policy. Both should be reformed. In performing both tasks, the Federal Reserve must be concerned to

⁹ Hoenig, Thomas M., (2013). "Basel III Capital: A Well-Intended Illusion," multilithed, Washington, April.

keep them working harmoniously. Current practice does not do that. Prudential policy will at times call for actions inconsistent with the goals of monetary policy. An example, one of many, occurred in the summer of 1982. Domestic and foreign bank failures required an end to the severe anti-inflation policy. Despite some strong opposition at the FOMC, Chairman Volcker chose to lower interest rates. Fortunately that worked well.

Prudential Regulation

My principal proposal for prudential policy is stated above. The Fed should recognize that its responsibility is to protect the public, not the banks, by safeguarding the payments system. That requires increasing required equity capital to shift potential losses to the major banks. The increase should be announced but phased in over several years. That shifts risk management and risk back to the banks. As compensation, industry should gain from a major reduction in specific regulation. The Dodd-Frank law should be repealed, and credit allocation should cease. The Federal Reserve should return to a "bills only" policy.

By shifting attention to the payments system instead of large failing banks, the Fed would recognize that the public good requires the stability of the economy and maintenance of the payments system. It does not require the solvency of banks operated by imprudent bankers. It is a system requirement not the protection of imprudent bankers.

To further strengthen its operation as lender-of-last-resort, the Fed should announce the collateral that would be acceptable in a crisis. By pre-announcing its rule, the Fed encourages banks to hold a requisite volume of such paper in uncertain periods. And the Fed should avoid moral hazard by lending at a rate above the pre-crisis rate on the collateral. As Michael Bordo and Anna Schwartz (1999) show,¹⁰ Baghot's rule worked reliably when the Bank of England followed it.

Monetary Policy

The many errors discussed earlier show the Federal Reserve requires changes that make policy more predictable, more rule like, less politicized. This is true especially of the failure to recognize that our current real problems of slow recovery, declining participation in labor force

¹⁰ Bordo, Michael and Schwartz, Anna J., (1999). "Monetary Policy Regimes and Economic Performance: The Historical Record." John Taylor and Michael Woodford, *Handbook of Macroeconomics*, Amsterdam: North Holland Publishers, Chapter 2.

to the lowest level in decades and increased part-time employment are not changed by expansive monetary action. The most likely reason for this persistent error is that the Federal Reserve has yielded to public and political pressures. Adopting and following a rule helps to reduce political pressures or at least to respond to them.

In a federal republic like ours, the U.S. Constitution disperses power among the three branches of government. Power to regulate money is given to Congress. The Federal Reserve is its agent. The principles governing our country are violated by the expansion that quadrupled the size of the Federal Reserve's balance sheet. No agency should have that much power unrestrained by explicit Congressional approval. A revision of the Federal Reserve Act must sharply limit the Federal Reserve's discretionary actions.

Further, does anyone believe that the uncertainty about current and future interest rates benefits the economy? Every large release appears to generate changes in the expected interest rate path. Speculators hang on the Chairman's words and most likely over-respond. This is much different from the period known as The Great Moderation when the FOMC remained rather consistent with a Taylor Rule.

More than 200 years ago, Henry Thornton warned that a monetary authority should not be beguiled by the praise from merchants and speculators who laud the initial effects of excessive monetary expansion. They cheer the rise in asset prices, as many have done recently. The more short-sighted do not look ahead to the later decline in asset prices. Their cheers encourage the rampant short-termism to which the Fed is prone.

The first reform task should be to restore some of the Fed's lost independence. Back in 1913, a common statement described the Reserve Banks as "bankers" and the Board as political. Over time, mainly in response to crises but also by the efforts of Chairman Martin, power within the System shifted to the Board, increasing opportunities for greater political influence. Over time, the Reserve Banks—most of the Reserve Banks—became less influenced by bankers and more responsive to the perceived problems in their districts.¹¹ During the 1970s inflation, the St. Louis Bank led opposition to inflationary policies. Recent opposition to credit allocation and overly expansive policies was led by the presidents of Reserve Banks in Philadelphia, Richmond, Kansas City and Dallas.

¹¹ The biggest exception is the New York Bank. It often serves as representative of the larger banks and the money market. See, for example, the charges made recently on National Public Radio.

In the 1920s, the presidents of the Reserve Banks chose open market policy. The Board had veto power only. Despite the Board's mistaken adherence to the real bills doctrine, the Banking Act of 1935 gave majority control of open market operations to the Board members. Reserve Bank presidents outside New York vote on policy only every two or three years.

I propose two changes. First, all presidents should vote at every meeting. Second, appointment and reappointment of presidents to their five-year terms should be the responsibility of the directors of each bank. The Board's role should be limited to objecting to appointments for cause.

The purpose of this change is to shift influence toward the general public and reduce political influence. That would be a major step toward increased independence.

Accompanying the change in the role of presidents, Congress should adopt a rule and require the Federal Reserve either to follow the rule or explain in writing why it deviated.

Independence is the absence of political influence. It is best maintained by announcing and following a rule. If it leaves the rule by declaring an emergency it must explain why. The FOMC should submit resignations together with the explanation. Congress which has constitutional authority for money can accept the explanation or the resignations. Several countries including the U.K. have adopted this requirement since I first proposed it at a meeting with the New Zealand Reserve Bank about 1985.

The Board responded negatively to the recent passage of a monetary rule by the House of Representatives. They want to retain unlimited discretion. The alternative is to restore the government of checks and balances that served well during much earlier history.

Postscript: What Are the Real Problems?

My references to real problems require explanation. Many businessmen regard the current administration as hostile, overly eager to prosecute them for alleged misdeeds. As the *Economist* featured on its August 30, 2014 cover and said in a lengthy article the Obama administration "criminalized the American company." The article said in part (p. 21): "The problem is not just that companies are ever more frequently treated as criminals. It is that the crimes they are accused of are often obscure and the reasoning behind their punishments opaque, and that it is far from obvious that justice is being done and the public interest is being served."

Given the high cost of proceeding to trial and the uncertain outcome of that course, businessmen settle out of court, admitting guilt and pay a fine. The *Economist* (p. 22) quotes a recent article in the *Harvard Law Review*. "Public enforcers often seek large monetary awards for self-interested reasons divorced from the public interest in deterrence. The incentives are strongest when enforcement agencies are permitted to retain all or some of the proceeds of enforcement."

The costs and uncertainty that result discourage investment. Greatly increased government regulation adds to the corporate burden by raising costs and increasing the uncertainty of returns. As one example the Dodd-Frank Act, according to one count, imposed 398 new regulations to an already heavily regulated industry.

Regulation is like an increase in taxation. Meltzer and Richard (2014)¹² show that, in a general equilibrium model, increasing tax rates widens the spread in the income distribution between upper and lower incomes. Evidence from the U.S., Great Britain, and France supports the model. The dynamic model supports the claims made by Kuznets.

Insert Charts here

Banking and finance are one example. Regulation to strengthen labor unions, regulate pollution, and control many business practices add to the intense disincentives acting like a tax on success. And the administration shows little interest in reducing the corporate tax rate and paying for the reduction by closing so-called loopholes—special provisions.

Porter and Rivkin (2012)¹³ asked 10,000 Harvard Business School alumni about why they did little investment. The respondents are officers at major U.S. companies. The article summarized the replies. The answers listed real factors, not money or interest rates. Among the responses were an ineffective political system, weak public education, complicated regulation, deteriorating infrastructure, and a lack of skilled labor.

Reducing burdensome regulation would reduce costs and shift resources to more productive uses. Repeal of regulations that increase rewards for not working and elimination of incentives to hire part-time workers would increase employment. Adopting a fundamental

¹² Meltzer, Allan H. and Richard, Scott, (2014). "A Positive Theory of Economic Growth and the Distribution of Income", unpublished.

¹³ Porter, M.E. and Rivkin, J.W., (2012). "The Looming Challenge to U.S. Competitiveness." *Harvard Business Review*, 90 (3), 54-61.

reform of the budget process that gradually eliminates the unsustainable current and future budget deficits without large tax increases is a vital step to increase economic growth.

Currently, we see instead claims that we face “secular stagnation.” That term originated in Alvin Hansen’s 1938 presidential address to the American Economic Association. His Harvard colleague Joseph Schumpeter responded by predicting continued growth in *Capitalism, Socialism, and Democracy*. Growth surpassed Schumpeter’s optimistic prediction.

In 1938, the problem was failure after New Deal policies. In 2014, it is again the failure of mistaken administration policy. The Federal Reserve’s errors are (1) failure to recognize the reason for slow growth, and (2) a mistaken belief that adding more reserves can make consumers and business optimistic.

Add to the real problems, the decline in growth elsewhere in the world. Federal Reserve policy cannot offset that real effect, but improved real policies could increase investment and domestic expansion.

During the Reagan years, the Federal Reserve first produced a recession and then a strong recovery. This was a monetary cycle. Contrast the current cycle. The Federal Reserve contributed to but did not cause the contraction, and it cannot produce a Reagan-like (or Volcker-like) recovery. In that recovery, with relatively high real interest rates of 6 to 7 percent in 1983 and 1984, tax cuts, and animal spirits created 17 million jobs during the 1980s. Unlike the current recovery, unemployment by blacks dropped 2.8 percentage points. Black household income rose 84 percent.

Opportunities for blacks followed from a policy very different from current policy of increasing transfers, anti-business actions, burdensome regulation and taxation. The administration must recognize that the Reagan policies worked much better. And the Federal Reserve should recognize that they cannot do much if anything about real problems. After its good response to financial failure, the Federal Reserve has made multiple errors that suggest strong political pressure either internally, externally, or both.

Our economic problems will continue until a pro-growth policy replaces the current fiscal and regulatory policy. Business investment will not revive until businessmen see more reason for optimism. That may begin to happen as the current administration becomes more of a lame duck that cannot continue to increase costly regulation.

PREPARED STATEMENT OF PAUL H. KUPIEC
RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

MARCH 3, 2015

Chairman Shelby, Ranking Member Brown, and distinguished Members of the Committee, thank you for convening today's hearing on Federal Reserve Accountability and for inviting me to testify. I am a resident scholar at the American Enterprise Institute, but this testimony represents my personal views. My research is focused on banking, regulation, and financial stability. I have prior experience working on banking and financial policy issues at the Federal Reserve Board, the IMF and, in the most recent past, for 10 years as Director of the FDIC Center of Financial Research where I served a 3-year term as chairman of the Research Task Force of the Basel Committee on Banking Supervision. It is an honor for me to be able to testify before the Committee today.

I will begin with a high-level summary of my testimony:

- The Federal Reserve was created by and enjoys duties and powers delimited by laws passed by Congress. Congress retains the legal right and social responsibility to amend the Federal Reserve Act and related legislation when such amendments are judged to be in the national interest. To exercise this duty, the Congress must have the right to assess the performance of existing Federal Reserve powers and responsibilities.
- New legislation is required should Congress decide to assess the Federal Reserve's monetary policy performance using the Government Accountability Office (GAO). The Federal Banking Agency Audit Act of 1978 restricts the GAO from evaluating Federal Reserve activities related to the Fed's monetary policy functions.
- No new legislation is required to use the GAO to assess many other Federal Reserve activities and process including the expanded regulatory powers granted to the Federal Reserve and the Board of Governors by the Dodd-Frank Act.
- Many Federal Reserve regulatory initiatives related to their Dodd-Frank expanded powers merit closer Congressional oversight. In this testimony, I will limit my discussion to three areas that have especially important ramifications for the safety and vitality of the entire U.S. financial system:
 - The Congress should exercise closer oversight over the Federal Reserve's ongoing interactions with international standard-setting bodies like the Financial Stability Board, the International Association of Insurance Supervisors, and the Basel Committee on Banking Supervision.
 - Congresses should instruct the GAO to assess the costs, benefits, and processes associated with the recurring Board of Governors stress tests mandated by Section 165 of the Dodd-Frank Act. These stress tests are very resource-intensive, both for banks and for the banking regulators, and there is little evidence that they are a cost-effective and objective means for regulating individual financial institutions.
 - Congress should assess potential conflicts that may be developing between the Federal Reserve's Dodd-Frank expanded powers over the domestic insurance industry and State insurance regulations. There are indications that new Federal Reserve examination and capital policies for insurers affiliated with a depository institution may be generating serious conflicts with existing State insurance supervision and regulation, contrary to the intent of the Dodd-Frank Act.

Federal Reserve Independence and Calls To "Audit the Fed"

The Federal Reserve was created by and enjoys duties and powers delimited by laws passed by Congress. Congress retains the legal right and social responsibility to amend the Federal Reserve Act and related legislation when such amendments are judged to be in the national interest. To exercise this duty, the Congress must have the right to assess the performance of existing Federal Reserve powers and responsibilities.

The Federal Reserve (Fed) was created by Congress in 1913 with limited responsibilities. These included: the establishment of regional Federal Reserve Banks; the provision of an elastic currency; the rediscounting of commercial paper; and, the supervision of Federal Reserve member banks. Over the years Congress amended the Federal Reserve Act to liberalize constraints on Fed operations, establish a Federal Reserve Open Market Committee, change the Fed's governance structure, require

periodic reports by the Fed Chairman to Congress, and assign the Fed specific monetary policy goals.

For most of the Fed's history, its battle for independence has been a struggle to formulate monetary policy without interference from the executive branch. Before the Fed won its independence from the U.S. Treasury in the early 1950s, many Administrations had run the Federal Reserve as if it were a captive finance arm of the U.S. Treasury.

Today the battle for Federal Reserve independence is a struggle to maintain minimal Congressional oversight over some of its operational areas, and a fight to maintain the legal luxury to carefully manage the Fed's operational transparency. The current struggle is probably less about safeguarding monetary policy from being high-jacked by parochial Congressional interests, but more about safeguarding unique Federal Reserve privacy privileges derived from its monetary policy functions.

Critics of "audit the Fed" proposals argue that the modern Federal Reserve is already transparent regarding its monetary policy deliberations and operations. True, the Fed now releases minutes and transcripts from its FOMC meetings with modest delays, and it has Web sites that document the details of its balance sheet and securities holdings. The Dodd-Frank Act pushed the Fed to disclose details about borrowers using the Fed's emergency credit facilities¹ and, beginning in 2012, the Fed was required to release detailed data on discount window borrowing² and open market transactions³ with a 2 year lag.

While the Fed has responded to public and Congressional pressures and become much more transparent in its disclosures in recent years, disclosure is not the same thing as oversight. Oversight involves independent evaluation of process and performance.⁴ The Federal Banking Agency Audit Act of 1978 gives the GAO audit authority over the Federal Reserve, but prohibited it from auditing:⁵

- Transactions with or for foreign central banks, Governments, or nonprivate international financing organizations
- Deliberations or actions concerning monetary policy
- Federal Open Market Committee transactions
- Discussions and communications between Federal Reserve members, officers, or employees associated with the prior three areas.

Given the uncertainties associated with the long-run economic impacts of the Fed's postcrisis monetary policy, some in Congress favor an expanded role for the GAO that includes the power to make an independent assessment of the Fed's monetary policy. For example, among other legislative features, S. 264 (the Federal Reserve Transparency Act of 2015) would remove all restrictions on the GAO's ability to audit the Federal Reserve. An alternative proposal, H.R. 5018 (the Federal Reserve Accountability and Transparency Act of 2014) would remove all GAO audit restrictions but also require the Fed to provide the Congress with detailed information regarding its monetary policy decision rule.

Congress created the Federal Reserve and Congress retains the power to evaluate Federal Reserve performance and amend the Federal Reserve Act. In this context, the "audit the Fed" debate is about whether Congress should deputize the GAO to evaluate Fed performance, not whether the Congress has the power to do so. Whatever the outcome of the "audit the Fed" debate, ideally Federal Reserve oversight should be designed to allow Congress to ask and receive answers to its questions and criticisms, including about the Fed's monetary policy, but still shield the Fed from undue pressure to alter monetary policy to satisfy short-run political interests.

The modern Federal Reserve does far more than monetary policy, and the Fed's nonmonetary policy duties also raise important accountability concerns. The Dodd-Frank Act (the Act) granted the Federal Reserve extensive new powers to formulate supervision, regulation, and bankruptcy reorganization standards for large financial institutions, and yet the Act itself includes no explicit congressional control over these expanded Federal Reserve powers. Indeed recent speeches by Federal Reserve

¹ http://www.federalreserve.gov/newsevents/reform_transaction.htm

² http://www.federalreserve.gov/newsevents/reform_discount_window.htm

³ http://www.newyorkfed.org/markets/OMO_transaction_data.html

⁴ This discussion borrows from Marc Labonte, "Federal Reserve: Oversight and Disclosure", Congressional Research Service, September 19, 2014.

⁵ 31 U.S. Code Sec. 714. The GAO normally has a number of separate Federal Reserve audits underway in any single year. The Federal Reserve System also has an Office of Inspector General (OIG) that is responsible for detecting and preventing fraud, waste, and abuse. The Fed's OIG also issues semiannual reports to Congress.

officials argue that these new Fed “macroprudential powers” are an essential complement to monetary policy, especially in the current zero interest rate environment.

Using its expanded regulatory powers, the Federal Reserve has the ability to shape the growth and development of the entire U.S. financial system. Unless the Congress exercises heightened oversight and control over the Federal Reserve’s use of these expanded regulatory powers, Congress will delegate decisions that determine the future vitality of U.S. financial markets to unelected Federal Reserve officials who are at best only weakly accountable to the public.⁶

In the remainder of my testimony, I will focus on the need for expanded congressional oversight over the Fed’s Dodd-Frank regulatory powers and related operations. Current legal authorities appear adequate and do not appear to restrict the GAO’s ability to audit the Federal Reserve’s regulatory activities, including audits on the Federal Reserve’s use of its expanded regulatory powers.⁷ In the remainder of my testimony I will highlight three areas where I think Congress should step up its oversight of the Federal Reserve’s enhanced supervision and regulation operations.

The Federal Reserve’s Relationship to International Standard Setting Bodies

The Congress should exercise closer oversight over the Federal Reserve’s ongoing interactions with international standard-setting bodies like the Financial Stability Board, the International Association of Insurance Supervisors, and the Basel Committee on Banking Supervision.

A recent GAO report⁸ examined the relationship between Financial Stability Oversight Council (FSOC) designations of nonbank financial firms for enhanced supervision and regulation by the Federal Reserve Board and prior designations of the same firms (as global systemically important institutions) by the Financial Stability Board (FSB). Since the Treasury and Federal Reserve are both members of the FSB designation group, this coincidence raised concern that the FSOC designation decisions were actually made during FSB deliberations, well before the FSOC completed its designation analysis.

The GAO reported that Treasury and Federal Reserve officials it interviewed argued that FSB designations imposed no constraint on the FSOC’s subsequent designations, but were just “another factor” taken into account in the FSOC deliberations. The GAO report also includes commentary and footnotes that suggest that GAO investigators had a difficult time believing these claims. The GAO noted that FSB documents report that national authorities are consulted before the FSB designates individual institutions.

A recent letter to G20 Ministers and Central Bank Governors dated February 4, 2015,⁹ raises new issues regarding the Federal Reserve’s participation in FSB work streams including work streams that make FSB designations. In the letter, FSB chairman (and governor of the Bank of England) Mark Carney, makes clear to FSB members that the decisions of the FSB are directives, which all FSB members are expected to carry out. In this letter, Carney states specifically that FSB members—including the Federal Reserve—have agreed to “Full, consistent and prompt implementation of agreed reforms.”

FSB chairman Carney’s letter notes that “FSB peer reviews” will cover “implementation of the G20 policy framework.” Carney reinforces the point mentioning that the FSB’s will use its oversight as a means for achieving its objectives: “The FSB will support the determined efforts of its members through enhanced monitoring of implementation and its effects across all jurisdictions. We will regularly report our key findings to the G20.”

The Federal Reserve apparently has agreed that its financial regulatory policies and institution designations will be guided by FSB directives that it has agreed to implement. Moreover, the Fed appears to have agreed to have its policy implementation overseen by a body dominated by European bureaucrats and chaired by the

⁶The Federal Reserve chairman and vice-chairman face Senate confirmation every 4 years. Federal Reserve governors are confirmed by the Senate, but limited to a 14-year term unless they are initially filling a partial term of departing governor. Regional Federal Reserve Bank presidents are not confirmed by the Senate.

⁷If however, there are legal impediments for GAO audits, simple amendments to the Dodd-Frank Act, like extending Section 122 powers to other sections of the Act, could explicitly provide the needed powers.

⁸Report to the Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, “Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process”, GAO, November 2014.

⁹<http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf>

governor of the Bank of England. While the U.S. Treasury was clearly aware of these developments by virtue of their own FSB membership and participation, it does not appear that the U.S. Congress received prior consultation before the Federal Reserve made these commitments.

Recent experience raises legitimate concerns that the Federal Reserve and the Treasury have been deciding on FSOC designations well before the FSOC finalizes its analysis. Given the unbalanced nature of FSOC member resources, pressure from the Treasury and the Federal Reserve Board on other FSOC members would likely be more than adequate to ensure a specific institution's designation. The November 14 GAO report documents that Federal Reserve has by far the largest staff allocated to the FSOC designations process and it is unlikely that few if any of the other FSOC members without a direct regulatory interest would challenge the Federal Reserve Board staff on its designation conclusions.¹⁰ Indeed Federal Reserve influence on FSOC designations goes beyond the Board of Governors as there are reports that Federal Reserve Bank of New York staff has also been heavily involved and influential in the FSOC designation process.¹¹

The recent FSOC decision regarding Metlife's designation for heightened prudential standards and supervision by the Federal Reserve Board highlights the overwhelming influence that the Federal Reserve Board and Treasury can have on the FSOC designation process, especially when the FSOC's members have no direct interest in the nonbank industry under consideration. Dissenting from the FSOC's Metlife designation was the council's independent member having insurance expertise and the Council's State insurance commissioner representative.¹² Moreover, the State insurance commissioners from five States—California, Connecticut, Delaware, New York, and North Carolina—independently wrote to FSOC Chairman Lew to protest the Metlife designation.

The Metlife dissent opinion written by the FSOC's independent member with insurance expertise was particularly informative about the relationship between FSB designation and subsequent FSOC decisions. It is worth quoting at length:

On July 18, 2013, the Financial Stability Board (FSB), an international organization within the umbrella of the Group of Twenty (G20), primarily comprising the world's finance ministers and central bankers, including the U.S. Department of the Treasury (Treasury) and the Board of Governors, announced that it had identified MetLife as a global systemically important financial institution (G-SIFI). G-SIFIs are declared by the FSB to be "institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries." Thus, MetLife was declared by the FSB as a threat not to just the U.S. financial system, but to the entire global financial system.

The FSB's announcement of the identification of MetLife and eight other insurers as G-SIFIs stated that its action had been taken "in collaboration with the standard-setters and national authorities;" and, that as G-SIFIs, these organizations would be subject to policy measures including immediate enhanced groupwide supervision, as well as to recovery and resolution planning requirements. It is clear to me that the consent and agreement by some of the Council's members at the FSB to identify MetLife a G-SIFI, along with their commitment to use their best efforts to regulate said companies accordingly, sent a strong signal early-on of a predisposition as to the status of MetLife in the U.S.—ahead of the Council's own decision by all of its members.

Despite subsequent assertions by some of the Council's members that the FSB and Council processes are separate and distinct, they are in my mind very much interconnected and not dissimilar. It would seem to follow that

¹⁰No other agency has a staff as large, technically sophisticated, or as academically credentialed as the Federal Reserve. For example, the Federal Reserve Board has more than 350 economists on its home Web page, <http://www.federalreserve.gov/econresdata/theeconomists.htm> and virtually all of them have Ph.D.s. This does not include Federal Reserve economists at the Reserve Banks. For example, the New York Fed alone lists 71 Ph.D. economists on its Web site. In contrast, on their respective Web sites, the CFTC lists 10 economists, the FDIC lists 19 economists, FHFA lists 15 Ph.D. equivalent economists, and the newly "economist fortified" SEC lists roughly 70 economists.

¹¹See the letter dated July 9, 2014, from Representative Garrett to William Dudley expressing concerns and additional information about the New York Fed's extensive involvement on the FSOC designation process.

¹²<http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf>

FSB members who consent to the FSB's identification of G-SIFs also commit to impose consolidated supervision, yet-to-be agreed-to capital standards, resolution planning, and other heightened prudential measures on those G-SIFs that are domiciled in their jurisdictions.

These pointed remarks from FSOC members make it apparent that the Congress must exercise closer oversight over the Federal Reserve's participation in FSB work streams. The Congress could exercise additional oversight using GAO audits, hearings, or through other legislation. For example, H.R. 5018 would require the Fed to notify congressional committees with jurisdiction and the general public 90 days prior to its intention to enter into or complete negotiations with international committees or standard setting bodies.

Regardless of the method the Congress selects, it needs to improve oversight of Federal Reserve's involvement in FSB initiatives, especially those regarding the capital regulation of insurance firms including any work streams on capital surcharges for insurance firms designated as global systemically important institutions as well as Federal Reserve involvement in FSB work streams focused on the designation of systemically important nonbank noninsurance (a.k.a. shadow bank) institutions and the enhanced regulation of "shadow banking" activities.¹³

When Federal Reserve officials refer to shadow banking, they are referring to activities that primarily associated with the asset management industry. In January 2014, the FSB issued a consultative document discussing a designation process for nonbank noninsurer systemically important firms.¹⁴ Firms fitting the FSB's consultative document profile are large asset management institutions. In November 2014, the FSB committed to issue policy recommendations that will establish regulatory minimum "haircuts" for securities financing transactions (securities lending and repurchase agreements) among shadow banks. Mirroring these developments, senior Federal Reserve officials used recent speeches to telegraph the Federal Reserve's intention to impose marketwide minimum haircuts on securities lending and repurchase transactions. Federal Reserve officials have also identified high-yield short-maturity by mutual fund investments as a shadow banking activity that should be discouraged as a potential source systemic risk.

The FSB is also in the process of recommending changes in insurance regulation. In October 2013, the FSB directed the International Association of Insurance Supervisors to develop a comprehensive supervisory and regulatory framework, including a risk-based global insurance capital standard for internationally active insurers as well as basic capital requirements (BCR) and higher loss absorbency (HLA) requirements for global systemically important insurance institutions. The Federal Reserve is an important member of this FSB insurance work stream and many observers believe that the Federal Reserve will eventually try to impose the FSB's insurance regulatory capital standards on State-regulated domestic U.S. insurers. The potential conflict with FSB insurance capital initiatives and U.S. insurance company capital requirements will be discussed in a subsequent section of my testimony.

If recent history is a guide, the policies the Federal Reserve develops in these and any other FSB work streams will form the basis of the policies the Federal Reserve subsequently attempts to impose as domestic regulations. It is important for Congress to step up its oversight of the Federal Reserve's involvement in FSB activities so it can make a timely evaluation of regulatory developments. Once FSB work streams conclude, it becomes more difficult for Congress to intervene and alter policies.

Congress Should Assess the Merits of Dodd-Frank Section 165 Stress Tests

Congresses should instruct the GAO to assess the costs, benefits, and processes associated with the recurring Board of Governors stress tests mandated by Section 165 of the Dodd-Frank Act. These stress tests are very resource-intensive, both for banks and for the banking regulators, and there is little evidence that they are a cost-effective and objective means for regulating individual financial institutions.

Section 165 of the Dodd-Frank Act directs the Board of Governors to establish heightened prudential standards that apply to bank holding companies with consolidated assets in excess of \$50 billion and nonbank financial firms designated by the FSOC. Included in Section 165 is the requirement that these institutions participate in an annual stress test exercise supervised by the Federal Reserve Board. The Federal Reserve is required to publish the results of these annual stress tests. In addition, financial institutions with \$10 billion in consolidated assets and a primary

¹³ http://www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf

¹⁴ http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf?page_moved=1

Federal regulator must conduct annual stress tests similar to the Board of Governors stress test and report the results to their primary Federal regulator.

Congress should consider an extensive audit of the Dodd-Frank mandate for recurring Federal Reserve Board stress tests. The audit should include an independent assessment of the Federal Reserve Board's stress test models and methodology including an assessment of the predictive accuracy (i.e., assess the confidence bounds) of the Federal Reserve's methodology. Assessments should evaluate the consistency with which the Federal Reserve Board applies its quantitative and qualitative stress test assessments both across institutions within a year and Fed's consistency across time. Independent assessors should identify weaknesses in the methodology and evaluate the Federal Reserve Board's internal approach for identifying and managing stress test methodology weaknesses. The examination should include the remediation process that occurs when a bank disputes the Fed's findings. Assessors should have confidential discussions with the financial institutions that have participated in these stress test exercises and report on these institution's concerns with the Fed's processes. The audit should evaluate the costs and benefits of using this methodology as a primary input in supervision and regulation of individual institutions.

The Board of Governors stress tests mandated by Dodd-Frank Act are expensive both for the banks and bank regulatory agency resources that could be deployed in other productive supervisory activities. These stress tests have dubious predictive power for identifying hidden financial system imbalances or for identifying risks in specific institutions financial institutions that would otherwise remain undetected. The quantitative outcome of these stress tests is arbitrary and completely under the control of the Federal Reserve Board because the stress tests estimates involve an overwhelming amount of judgment on the part of the stress tester. Consequently stress test results cannot be replicated by different independent stress testers. Since banks cannot accurately anticipate the Fed's stress test results even when they know the macroeconomic stress scenarios, this mandatory process interjects a huge and unproductive source of uncertainty in the bank planning process.

Board of Governor stress tests are a particularly problematic form of enhanced prudential supervision because there is no objectively correct answer in a Board of Governor's stress test. Participants are required to produce specific numerical answers questions that have no single correct answer knowing that the Board of Governors has wide discretion to decide the "correct" at will by changing modeling assumptions. Moreover, institutions have no mechanism to challenge the Board of Governors on the accuracy of Board's preferred correct answer.¹⁵

Many have questioned the value of macroeconomic scenario stress tests for identifying and mitigating financial sector excesses,¹⁶ and yet the Federal Reserve System spends an enormous amount of resources and requires covered institutions to spend significant sums on the activity. Already, Fed stress tests have missed the "London Whale" at JPM Chase and a multibillion-dollar hole in Bank of America's balance sheet. Fannie Mae and Freddie Mac both passed Government-designed macroeconomic stress right up to the time they failed in September 2008. Before the financial crisis, many countries produced financial stability reports that included bank stress tests and none anticipated the crisis. And there are many additional examples where similar tests failed to identify subsequent problems.

A stress-test based approach for setting bank capital has two gigantic measurement problems. First, the macroeconomic scenario must actually anticipate the next financial crisis. And secondly, regulators must be able to translate the macroeconomic crisis scenario into accurate predictions about actual bank profits and losses.

Few regulators possess the prescience necessary to accomplish this first step. In 2006, the subprime crisis was less than 2 years away, but the Federal Reserve did not see it coming. The New York Fed's staff was publishing papers that dismissed the idea of a housing bubble and the Federal Reserve Chairman's speeches argued—worst case—there may be some "froth" in local housing markets. Even as the subprime bubble burst, the new Fed Chairman publicly opined that the economy would suffer only minor fallout.

¹⁵I am adapting Kevin Dowd's analogy in, "Math Gone Mad: Regulatory Risk Modeling by the Federal Reserve", CATO Policy Analysis No. 754, September 3, 2014.

¹⁶For some examples, see: C. Borio, M. Drehmann, and K. Tsatsaronis, "Stress-Testing Macro Stress Testing: Does It Live up to Expectations?" Bank for International Settlements, November 2011; or, Til Schuermann, "The Fed's Stress Tests Add Risk to the Financial System", *The Wall Street Journal*, March 19, 2013; or, L. Guerrieri and M. Welch, "Can Macro Variables Used in Stress Testing Forecast the Performance of Banks?" Federal Reserve Board Finance and Economics Discussion Series 2012-49.

Even if a stress scenario correctly anticipates a coming crisis, the crisis must be translated into individual bank profits and losses. However, bank profits and losses are not very tightly linked with changes in macroeconomic indicators. Quarter-to-quarter bank profits do not closely follow quarterly changes in GDP, inflation, unemployment, or any other macroeconomic indication. The best macroeconomic stress test models explain maybe 25 percent of the quarterly variation in individual bank profits and losses, meaning that more than 75 percent of the variation in bank profit and losses cannot be predicted using GDP, unemployment, or other business cycle indicators.

Because of these measurement issues, bank loss predictions from macroeconomic stress tests have very little objective accuracy. Even using the best models, there remains a great deal of uncertainty surrounding how each bank may actually perform in the next crisis, presuming the stress scenario anticipates the crisis.

These issues make macroeconomic stress testing more of an art than a science and a tool that is inappropriate for the supervision on an individual institution. There are just too many places to make mistakes. There is no formula or procedure that will lead to a single set of stress test bank loss estimates that can be independently calculated by different stress test modelers. Thus, it is not surprising that the Board of Governors and the U.S. banks rarely agree on stress test results.

Less widely appreciated is that these coordinated macroeconomic stress tests encourage a “group think” approach to risk management that may actually increase the probability of a financial crisis.¹⁷ Stress test crisis scenarios have to be specific so that banks and regulators can model the same event. Moreover, the Board of Governors imposes some uniformity in loss rates across all designated banks by using its own stress test estimates. The Board of Governors is very much like a coach or a central planner that tries to ensure some coherence in each designated firms estimates and capital plans. Perhaps unintentionally, by requiring all firms to approach the stress test problem in the same way as the Board of Governors, the process encourages all large institutions to think and operate the same way.

A final weakness concern is that the stress test process requires the Board of Governors to be intimately involved in modeling the operations and exposures of each large banking institution. The process requires the Federal Reserve Board to use its own judgment to set each large bank holding company’s “stress tested” capital plan. These regulations have become so intrusive that the regulator virtually runs the bank. In such a situation, it becomes difficult for the regulator to admit a mistake and allow an institution to fail.

Congress Should Examine Conflicts Between Federal Reserve and State Insurance Regulation

Congress should assess potential conflicts that may be developing between the Federal Reserve’s Dodd-Frank expanded powers over the domestic insurance industry and State insurance regulations. There are indications that new Federal Reserve examination and capital policies for insurers affiliated with a depository institution may be generating serious conflicts with existing State insurance supervision and regulation, contrary to the intent of the Dodd-Frank Act.

The new regulatory powers granted by the Dodd-Frank Act to the Federal Reserve could lead to substantial changes in insurance regulation. Since the McCarran-Ferguson Act of 1945, insurance regulation has been conducted by the States and their insurance commissions. The Dodd-Frank Act created a new Federal Insurance Office within the U.S. Treasury, but the Act purposely limited the new office’s responsibilities to monitoring and advisory duties; it does not have national supervisory responsibility.

Notwithstanding the fact that the Dodd-Frank Act intentionally avoided the creation of a national insurance regulator, many in the insurance industry believe that the Federal Reserve is using its new Dodd-Frank powers to become the de facto national insurance supervisor. Moreover, the industry is concerned that these developments could lead to wholesale revisions in the supervision and capital regulations that apply to State insurers and result in the imposition of bank-style capital regulation on the insurance industry.

Section 312 of the Dodd-Frank Act transferred regulatory authority and rule-making over thrift holding companies and insurance holding companies that owned depository institutions from the Office of Thrift Supervision to the Federal Reserve. Section 604 of the Act authorizes the Federal Reserve to conduct examinations of the nonbank subsidiaries and affiliates of these holding companies even if these institutions have a functional regulator.

¹⁷Til Schuermann, op. cit. makes this argument.

Section 312 empowers the Federal Reserve to examine insurance companies whereas, prior to the Dodd-Frank Act, bank regulators were prohibited from examining these State regulated entities. Since acquiring its new powers, the Federal Reserve has launched an extensive examinations program for insurance companies owned by thrift and insurance holding companies. These examination often are conducted using newly hired Federal Reserve examiners with little or no insurance experience, even though these insurers being examined are already fully regulated and supervised by State insurance commissioners.^{18 19}

These Federal Reserve insurance examinations are causing considerable concern for insurers. Industry sources suggest that the Federal Reserve examiners are less than fully conversant with State insurance regulations and they frequently find that insurer subsidiaries or affiliates are undercapitalized if their capital levels do not agree with bank capital standards, even when these insurers are well-capitalized according to long-standing State insurance regulations. Representatives of the insurance industry are worried that, unless Congress intervenes, these Federal Reserve insurance examinations and associated holding company regulatory capital restrictions will eventually lead to the imposition of bank regulatory capital standards on the entire insurance industry.

Section 606 of the Dodd Frank Act allows the Federal Reserve to apply its bank holding company “source of strength doctrine” to the insurance and thrift holding companies it now regulates. Industry sources suggest that the Fed’s erroneous examiner opinions alleging weak capital positions at insurance subsidiaries and affiliates have lead the Fed to conclude that the consolidated capital positions of some holding companies must increase. Again, in the opinion of the insurance industry experts familiar with the specific details of these cases, these mandated capital increases are not addressing true holding company capital weaknesses. Instead they are the result of long-standing and appropriate differences between the capital regulations for insurers (set by the States), and consolidated capital standards for banks (set by the U.S. bank regulatory agencies in consultation with the Basel Committee on Bank Supervision).

Industry representatives suggest that the Federal Reserve’s approach for assessing the capital position of thrift and insurance holding companies could lead to new insurance industry constraints on dividend payments or other transactions that return capital to shareholders. The Fed can apply its holding company capital rules even in cases where the holding company is comprised predominately of insurance related activities and includes a subsidiary depository institution that holds only a tiny fraction of the holding companies’ assets.²⁰ Recent congressional testimony by Federal Reserve Board Senior Advisor Thomas Sullivan did not allay industry concerns when he reported, “Our principal supervisory objectives for insurance holding companies are protecting the safety and soundness of the consolidated firms and their subsidiary depository institutions . . .”²¹

With the Fed’s acquisition of thrift and insurance holding company supervision and the three large FSOC-designated insurance companies now subject to enhanced supervision and regulation by the Federal Reserve Board, the Federal Reserve is now the consolidated supervisor of companies that hold about one-third of the asset in U.S. insurance industry.²²

Reflecting these new insurance powers, in 2013 the Federal Reserve has joined the International Association of Insurance Supervisors—the international standard setting body for insurance regulation. The Federal Reserve is now a member of the IAIS work stream that is developing global standards for the supervision and regulation internationally active insurers, including regulatory capital standards for insurance groups.²³ This work is part of the overall G20 financial stability initiative coordinated by the FSB. The Federal Reserve is also a member of the IAIS group that is responsible for identifying global systemically important insurers and design-

¹⁸ Testimony of Thomas Sullivan of the Board of Governors before the House Subcommittee on Housing and Insurance, November 18, 2014.

¹⁹ For official Federal Reserve guidance on these examinations, see <http://www.federalreserve.gov/bankinforeg/srletters/sr1111a2.pdf>.

²⁰ For a detailed discussion of the issues that concern the industry see, *Letter to Regulatory Agencies on Behalf of Nationwide Mutual Company regarding “Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action”*, http://www.federalreserve.gov/SECRS/2012/December/20121206/R-1442/R-1442_101712_109102_441597364672_1.pdf.

²¹ See Thomas Sullivan’s testimony.

²² Ibid.

²³ Ibid.

ing the enhanced regulatory and supervisory framework that will apply to these institutions.

The Federal Reserve is a member of the IAIS work stream charged with developing groupwide capital standards for insurance groups. These consolidated capital requirements are similar to the consolidated capital requirements for bank holding companies. For some years, Europe has been developing new insurance capital standards called Solvency II. Solvency II standards are in many respects similar to the Basel capital standards for banks and bank holding companies. In fact, Solvency II and is often called “Basel for insurers.” The similarity between bank and insurance capital requirements in Europe is no accident because European insurance activities are often conducted as part of a universal banking organization. Because the IAIS membership is dominated by European insurance supervisors, many believe that, in the end, any new IAIS groupwide standard will strongly resemble Solvency II.

In contrast to Europe, the U.S. does not have a consolidated capital standard for insurers. Historically, the U.S. approach to insurer capitalization has served the industry well. It has not resulted in any systemic weaknesses and it likely works to contain contagion risk because it limits interdependencies among insurance companies. U.S. capital standards are set for individual State insurance entities that are incorporated and fully capitalized within a single State. They are licensed, regulated and if need be, liquidated at by the State insurance regulator. Consolidated group capital has not been an important issue in the U.S. because each State chartered insurance entity must be fully capitalized and cannot rely on capital support from a larger insurance group.

The extent of Federal Reserve involvement in insurance regulation and the potential for the Fed to impose significant changes on insurance supervision and regulation was unlikely to have been anticipated by Congress. The Federal Reserve is now poised to become the de facto national insurance regulator that Congress declined to create in the Dodd-Frank Act. The Fed is empowered to exam firms that hold one-third of insurance industry assets even though these firms are examined by State insurance regulators. The Fed is now also the most influential U.S. regulatory member charged with designing new capital and supervisory processes in the IAIS/FSB work stream. The Fed is already showing a preference to impose bank capital regulations on insurance holding companies and there is industry concern that the Fed may agree to Solvency II bank-like capital regulations in its IAIS insurance capital work stream.

This concludes my written remarks. Thank you for the opportunity to testify on these issues.

PREPARED STATEMENT OF PETER CONTI-BROWN

ACADEMIC FELLOW, STANFORD LAW SCHOOL, ROCK CENTER FOR CORPORATE GOVERNANCE

MARCH 3, 2015

Mr. Chairman, Ranking Member Brown, Members of the Committee, my name is Peter Conti-Brown and I am an Academic Fellow at Stanford Law School’s Rock Center for Corporate Governance. In July, 2015, I will be an assistant professor of legal studies and business ethics at the Wharton School of the University of Pennsylvania. I am here today as a legal scholar and a financial historian who studies the institutional evolution of central banking, especially in the United States. Much of what follows comes from a paper I presented on March 2, 2015, at the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution. As noted above, I reiterate that I speak only on my own behalf.¹

It’s been an exhausting 7 years to be a central banker. It began in the summer of 2007 and extended through the shotgun marriage between JPMorgan Chase and Bear Stearns, the concomitant resurrection of unusual lending authority, the ongoing implementation of unconventional monetary policy, and so much else in between. To paraphrase Thomas Paine, these have been the times that try central bankers’ souls, that test the resolve of the summer hawk or the sunshine dove.

But these central banking times have been trying not only, perhaps not even especially, for central bankers, but also for the public they serve. This heterogeneous

¹ Much of the detail, the citations, and other supporting evidence is contained in that paper: “The Twelve Federal Reserve Banks: Governance and Accountability in the 21st Century”, available at http://www.brookings.edu/media/Research/Files/Papers/2015/03/02-fed-banks-21st-century/fed_banks_21st_century.pdf?la=en.

public—including long-standing Fed watchers and those who have only recently realized that the United States has a central bank, those who love the Fed, and those who hate it—has not always, or indeed not even very often, been fully comfortable with these decisions. The emergency lending—the “bailouts,” in the popular if misleading parlance—that began with Bear Stearns and accelerated through the alphabet soup of Fed and Treasury programs gave birth to the populist-libertarian revival of 2010. And the monetary policy response, especially in unconventional monetary policy, has only exacerbated these tensions. The views of once and future presidential hopeful Rick Perry are emblematic of the feelings of many in the American polity: quantitative easing was “printing more money to play politics,” and was, by Perry’s lights, “almost treacherous, or treasonous.”² In the United States, the Fed and its chair were among the most admired of agencies and officials in Government at the time of, for example, Alan Greenspan’s retirement in 2006; just a few years later, they were among the lowest (Conti-Brown, 2015b).

As a consequence, there has been no shortage of discussions—during the crisis and unceasingly since—about how to reform the Fed. Most of these discussions, though, have been on reforming the Fed’s functions. That is, changing the way it lends money in an emergency, how it determines which financial institutions are systemically important, how it accounts for its spending and decisions, how it determines its models of the economy, and how it makes monetary policy. The answer to the question: “What does the Fed do, and what should it do?” is no doubt essential to our understanding of what lessons for central banking we are to take from the recent crisis.

Less discussed, however, is the Fed’s structure, raising the question, “Who is the Fed?” Public and scholarly attention on the Fed usually focuses on a monolithic it, or on the personal she or he. In fact, the standard grammatical practice—followed in this paper—is to refer to the Federal Reserve (or just “the Fed”) as a proper noun. The Fed raised interest rates; the Fed bailed out AIG; the Fed issued new banking regulations; the Fed fired a bank examiner for challenging Goldman Sachs. But this linguistic practice is an institutional, and even grammatical, error. The term “Federal Reserve” is not a noun, but a compound adjective. There are Federal Reserve Banks, Federal Reserve Notes, a Federal Reserve Board, and, taken together, a Federal Reserve System, all created by the Federal Reserve Act of 1913. But there is no “Federal Reserve” by itself.³ This vocabulary failure belies a harder problem for thinking about the Federal Reserve System—even though we rarely refer to it as such, to paraphrase Kenneth Shepsle, the Fed is a “they,” not an “it.”⁴

This is not a pedantic grammatical point. Understanding the Fed’s complex ecosystem and the institutional actors within the Federal Reserve System is essential to understanding the space within which the Fed makes policy. It also speaks to the very independence that some distrust and others hold very dear. This complexity also illustrates a problem not just of public understanding—though it is certainly that—but also one of governance. When the public is faced with a monolith, all debates about Fed actions—no matter where they occur within the system, and no matter what those actions may be—easily spiral into debates. Such debates involve the first principles about the gold standard, the Coinage Clause of the U.S. Constitution, and the pure democratic virtues of Thomas Jefferson over the venal tyrannies of Alexander Hamilton.

My book, *The Power and Independence of the Federal Reserve* takes up the largely descriptive task of laying out the governance, independence, and structure of the Federal Reserve System, especially as that structure has evolved over time.⁵ It relates it to the conception of central bank independence that grew out of a historical moment in the 1980s and 1990s. But this paper examines one aspect of the largely normative issue of central bank design: not what the Fed is, but what it should be. In particular, this is a question of the federal in the Federal Reserve, looking at the curious decisions of institutional design to place some authority in a Government agency in Washington, DC, and other authority dispersed unevenly in mostly private regional Federal Reserve Banks. It is a question of whether or not this failed experiment in quasi-federalism and central banks (and without question, it was a failure) should inform our discussions of structural reform today.

²Zeleny, Jeff, and Jackie Calmes, 2011. “Perry Links Federal Reserve Policies and Treason”. *The New York Times*, U.S. Politics, August 16.

³To highlight this point, in the original debates during, and for many years following, the passage of the Federal Reserve Act of 1913, the only word capitalized was frequently “Federal”: it was the “Federal reserve board” and the “Federal reserve banks.”

⁴Shepsle (1992).

⁵Conti-Brown (forthcoming, 2015).

My policy prescriptions vary from those offered by Sen. Paul, who recommends an audit of the Federal Reserve, and different too from the bill pending before the House Financial Services Committee, that would mandate that the Fed follow a monetary policy rule or explain its deviations to congressional hearings and the Government Accountability Office. These bills focus on the policies of the Fed. Given the massive uncertainty about the future and the real potential for mischief that subjecting the Federal Reserve to the day-to-day of political pressure could produce, I favor instead focusing on the Fed's governance structure and the proposal that we should have more presidential and congressional control at the highest level of policymaking at the Federal Reserve.

The Reserve Banks

Once we accept that there is a role to play for Government in implementing policies that redound to the social good—a sometimes contested proposition, but one that enjoys relatively widespread support—we must answer two additional questions: (1) How will those governmental agents be selected? and (2) Will their policies reflect that “social good,” or some other set of values?

This is the fundamental question for the Reserve Banks' continued participation in the formulation of the Nation's banking and monetary policies. As I explain in more detail elsewhere, the Reserve Banks—especially the Federal Reserve Bank of New York—have the potential to make policy and constitutional trouble. Reforming the Reserve Banks by revisiting the question of the appointment of their leaders should be the top priority of any politician who wants the system to conform to constitutional requirements and to allow meaningful democratic accountability.

The problems with the Reserve Banks are in the nature of their appointment and restrictions on their removal. There are three alternatives for resolving this problem: (1) make the U.S. President responsible for appointing the Reserve Bank presidents; (2) make only the president of the Federal Reserve Bank of New York a Presidential appointment, or most convincing, (3) make the Board of Governors responsible for both appointing and removing the Reserve Bank presidents. I will address each in turn.

The first alternative is the perennial proposal to vest the appointment of the Reserve Bank presidents in the U.S. President, with the Senate confirming those appointments. This would resolve absolutely the constitutional issues of appointment and removal, which I address in more detail elsewhere.⁶ And the statute could be clarified to demonstrate a hierarchy in nonmonetary policy, placing the Reserve Banks under the supervision of the board. But this would also allow the Reserve Banks to remain on the FOMC as equals to the governors. Given the diversity of their views, this seems a promising reform.

Of course, the recent trend toward failing to fill the appointments on the Board of Governors may suggest that the fate would be the same for the newly installed Presidential appointments at the Reserve Banks, as discussed above. This possibility also points toward rendering the Reserve Banks fully accountable to the Board of Governors. At the same time, it is not likely that we would see the same vacancy rates at the Reserve Banks as we have at the Board of Governors, for two reasons. First, filibuster reform made it much harder for the minority party to block presidential nominees. And second, the vastly expanded Senate franchise at the Federal Reserve might make Reserve Bank presidents look more like ambassadors or U.S. attorneys, positions that don't usually attract the same kinds of partisan political attention we associate with Senate gridlock. Even so, this concern is enough to weigh against a policy proposal in favor of rendering the Reserve Banks presidential appointments.

There's another reason why making the heads of the 12 Reserve Bank Presidential appointments seems a misplaced policy. It would almost be sentimental. If all members of the FOMC become Presidential appointments, the value of a 19-person committee must come from something other than the process of their appointment (the strongest justification under the current arrangement). If the problems that inhere to the other proposed alternatives are enough to defeat those proposals—that is, to subject the Reserve Bank presidents to board removal, or board appointment and removal—it may be appropriate to entertain the idea that motivated Marriner Eccles back in 1935: removing the Reserve Banks entirely from the world of making policy. The Reserve Banks could continue to exist as branch offices of the Federal Reserve in the 12 cities where they are located, but they would not participate on the FOMC. And, consistent with Carter Glass's original conception, the Fed could then expand its presence even more evenly to other cities, even re-

⁶See Conti-Brown, “The Institutions of Federal Reserve Independence”, *Yale Journal on Regulation*, forthcoming 2015.

moving regional banks from places where they no longer serve a useful purpose. That way, we could revisit some of the decisions about the design of the system that were curious even in 1914 when they were decided: Do we really need two Fed branches in Missouri, and only one west of Dallas?

Third, Senator Jack Reed (D-RI) has proposed making only the president of the Federal Reserve Bank of New York subject to Presidential appointment and Senate confirmation. The Federal Reserve Bank of New York and its president are by far the most important players in the system from both banking and monetary policy perspectives. Giving more presidential and congressional accountability to this key figure in the financial system would go a very long way to ensuring that the public can participate, appropriately, in the governance of its central bank.

I would prefer a third proposal: Vest the appointment and removal of the Reserve Bank presidents in the Board of Governors.⁷ There would no longer be multiple layers of removal protection, nor a complicated asymmetry in the appointment and removal dynamic. In that sense, the change would complete the revolution in central banking design that Marriner Eccles began 80 years ago.

This solution does present something of a quandary. If the Board of Governors fully appointed, and could remove at will, the Reserve Bank presidents, what would be the point of the 19-person FOMC at all? Wouldn't this just make the Federal Reserve Bank president a member of the Fed's senior staff? And why give them votes on the Nation's monetary policy?

The answer to these questions seems obvious. Making the Reserve Bank presidents fully subject to board appointment and removal would also mean the abolition of the FOMC and the consolidation of all the Fed's legal authority at that board. As mentioned earlier, even for those who favor the mixed committee system as a check on inflation, there are sharper ways to accomplish this task. It's unclear what we gain by having such an unwieldy committee.

One argument in favor of retaining the current committee size is that each Reserve Bank president comes equipped to FOMC meetings, at least in part, with research conducted independent of the board's own staff assessments. But this feature of the Fed's dispersed research function is preservable, if it is indeed desirable. That is, governors can gain better access to staff assessments, rather than consume only the options the chair has shaped with the staff ahead of FOMC meetings. In other words, getting diversity of research views presented at the FOMC is not tied to the existence of a 19-person committee.

Federal Reserve Staff

There are currently 15 divisions at the Fed's Board of Governors, each appointed by the Board, none vetted publicly. For some of them, and perhaps just for one of them, I would propose that the Senate consider revising that appointment process.

For example, the Director of International Affairs exercises extraordinary policy authority on behalf of the United States. True, there is much in the position that is very technical. But there is much, too, that is highly diplomatic. If the Director of International Affairs is seen in the latter role—as essentially the Fed's chief diplomat—presidential appointment is very desirable. The Fed's role in the international economy has increased substantially in the last 30 years. The argument for presidential appointment for this key position is very strong.

The strongest argument for presidential appointment among Fed staff is in the position of General Counsel. The Fed's chief lawyer, as discussed in chapter four, exercises extraordinary authority. As this book has argued at great length, the laws of Fed independence and authority are difficult to parse. The idea that the exercise of legal expertise as a purely technocratic function has been dead for eighty years. These positions require value judgments informed by technical expertise. While I don't argue that these functions should be subject to constant debate on the floor of the House, the case for allowing the public to vet the appointment of these lawyers is essentially ironclad.

Two points of comparison are useful here. First, unlike the case with the other "barons" of the Fed staff, the Fed Board is not in a position to exercise significant oversight over the Fed's chief lawyer. As discussed above, the Fed has become increasingly dominated by economists, a transition away from a tradition of bankers and lawyers. There are good reasons for this transition, but one consequence is that

⁷The Federal Reserve Act does give the Board of Governors approval over the appointment of the Reserve Banks. While there are anecdotal reports about the frequency with which the board exercises this veto, this still needs to be confirmed systematically. "The president shall be the chief executive officer of the bank and shall be appointed by the Class B and Class C directors of the bank, with the approval of the Board of Governors of the Federal Reserve System, for a term of 5 years" (12 U.S.C. §341).

the Fed is not in the position to push back against or even, perhaps, understand the issues of value judgments that a lawyer must make when making a recommendation as monumental as what kind of collateral counts when extending emergency loans or whether an enforcement decision matches the degree of non-compliance with which it is associated. This is not the fault of the Board, but a reflection that theirs is largely a different kind of expertise. As of this writing, there are two lawyers on the Fed's Board, but only one who has spent a significant portion of his career dealing with the legal issues relevant to the Fed's regulatory work.

Second, while other general counsels at administrative agencies are not subject to presidential appointment, the Fed's chief lawyer makes judgments of extraordinary importance that are unlikely to ever be subject to judicial review. Courts have made clear for 80 years that they will not review the Fed's decision about monetary policy, including when those decisions require novel interpretations of law. And in the crisis, emergency decisions were made that have been effectively removed from judicial review, including violations of State corporate law and issues raised by the Constitution. While judicial review still occurs in many of the Fed's regulatory determinations, in places where value judgments are of the most consequence, the Fed's lawyer is the first and last word on what the law allows or forbids. For this reason, the Fed's chief lawyer should be a presidential appointment.

Other Policy Proposals

There are two proposals for reform that have circulated historically, perennially, and are pending before this Committee or the House Financial Services Committee. The three proposals are (1) to audit the Fed annually through the Government Accountability Office; and (2) to legislate a monetary policy rule and require the Fed to follow it or explain its deviation to congressional committees with, again, support from the GAO.

The first proposal has been around for decades and continues as a perennial favorite for those who seek to understand and reform the Fed. That proposal is to subject the Fed to an annual, transparent audit performed by the Government Accountability Office. Many within the Fed view the "Audit the Fed" bills and their proponents with fear and loathing and equate the practice with an end of Fed independence. I don't share those convictions, at least not completely. That is, the public audit part of the proposal strikes me as a scholar and as a citizen as an essential part of the way we can understand what the Fed, what the Fed does, and who on the outside tries to influence Fed behavior. And, historically, Congress has mandated at least two partial public audits—in 1978 and 2010—that the Fed vociferously opposed. What we learn about Fed practices, especially from its lending behavior during the crisis, is essential to our comprehension of this opaque institution.

What troubles me about the Audit the Fed bills is the regularity of those audits. The potential for one-off audits is a sufficient deterrent for the truly scandalous behavior. As noted, it is frankly astonishing that the Fed, given its robust financial independence, has never had a scandal such as those that have plagued other agencies including, ironically, the GAO itself. The problem with the regularity of the audits is that they will inject politics deep into the everyday operations of the Fed. At present, the Fed and its officials testify regularly before Congress, but more in a question and answer format. These hearings are public and allow for members of both the House and the Senate committees to explore any question of interest. And the committees can summon the Fed at their own prompting.

What an audit would do is force the Fed to structure all of its activities toward that kind of transparency. While not as much of an intrusion as the hostage holding that would occur through the appropriations process, it would significantly decrease the distance between the Congress and the Fed that currently exists. Because of the deterrent benefits of potential audits and the opportunities that members of Congress already have for public accountability through congressional hearings, I see annual audits as part of the same problem.

The second proposal is the newest, although it too has antecedents in history. That proposal would require the Fed to follow a version of the "Taylor Rule", a model of the monetary policy for the years 1987–1992 written by Stanford economist John B. Taylor in 1992 and causing a large outpouring of research from Taylor and others following in his wake. The rule would require the Fed to conform its monetary policies to a basic formula that relates a number of variables, including the level of current inflation, unemployment, and targets for economic growth and inflation. The Fed would input a standard set of coefficients to its empirical determination of the economic indicators (inflation, unemployment, the output gap, and so forth); the interest rate is the output of the equation. Within 48 hours of each FOMC meeting, the FOMC would submit to the GAO its determination of the Tay-

lor Rule and be audited thereafter by the GAO. If the Fed deviated from the Taylor Rule, it would have to appear before a congressional committee to explain itself.

This is a very controversial bill, I think for good reason. I am not an economist and have no particular insight into whether the Taylor Rule reflects the best version of monetary policy. But economists do not agree either. Some of the concerns are not about the need for Rules—the Fed has been following a modified version of the Taylor Rule for years. It is on the value of those coefficients, and whether the determinations made in the Taylor paper, based on data from 1987–1992 are in fact portable to all times and all places.

While my research tells us little about whether monetary rules are superior, it does tell us something about the nature of law and personnel. Intricate rules like the one proposed in the Taylor Bill are subject to legal entropy. By inserting the GAO into the monetary policy equation, we cannot predict the institutional consequences. It is not far-fetched to predict, depending on the personnel choices made under the Taylor Bill regime, monetary policy drift from the central bank to the GAO. This result isn't guaranteed by the bill, of course, but the point of this book is to argue that the legal institutions established at one time period cannot be trusted to stay in place. For this reason, the legal modifications proposed here are entirely about public scrutiny of personnel decisions, not policy rules.

To put the point differently, the Taylor Rule may well be exactly the right approach to monetary policy. If that's the case, we should appoint John Taylor to the Fed, not insert the GAO and congressional committees into the micromanagement of monetary policy.

Conclusion

The impulse behind Fed reform on the left and the right comes from the recognition that the Fed wields extraordinary authority that the public does not always understand. At the same time, one of the central innovations of institutional design in the 20th century was to create central banks that could exist apart from the day-to-day of electoral politics. The task for the Congress is to continue to maintain that buffer from politics without eliminating the Fed's public accountability. I believe focusing on the Fed's governance as opposed to micromanaging the Fed's policies is the best way to achieve that balance.

**RESPONSES TO WRITTEN QUESTIONS OF
CHAIRMAN SHELBY FROM ALLAN H. MELTZER**

Dear Mr. Chairman, I would like to offer a brief statement before answering your questions. My statement tells you why I believe Federal Reserve reform is important and necessary.

In the past few years—2008–14, the Federal Reserve quadrupled the size of its balance sheet by buying up large parts of the Government debt and Government guaranteed mortgages. By these actions, the Federal Reserve added several trillion dollars to available bank reserves.

The end result of these actions is highly uncertain. One can be skeptical that it will work out to the benefit of the Nation, but the outcome is uncertain.

Even if the outcome is reached without serious problem, the Congress must ask if it can permit an agency of Government to have the unrestrained power to quadruple its balance sheet without any formal oversight by the Congress.

My answer is a firm NO. That is not the Government of limited powers that safeguards our liberty. Congress must legislate to restrict future actions of this kind by passing a rule.

Q.1. *The Wall Street Journal* recently reported that much of the authority previously delegated to the New York Fed to oversee the many of the Nation's largest banks has been, in effect, revoked and given to a secret committee run by Governor Tarullo. One of Dallas Fed President Fisher's proposals calls for moving supervision of a "systemically important" bank to a district outside where that bank is based in order to address the potential for regulatory capture. Is it better to centralize control of systemic regulation at the Board of Governors of the Federal Reserve System or rotate it among Federal Reserve Banks?

A.1. I agree with President Fisher. Removing supervision and regulation of gigantic banks outside their home district reduces the special privileges that the largest banks get from their Federal Reserve Banks. I do not believe that Governor Tarullo or the Federal Reserve Board is the proper place to house regulatory oversight. From the start of the Federal Reserve System in 1913, the board has been regarded as the most political part of the system. That is more true now than in the past.

Regulation and supervision come closest to the public interest if the regulators are disinterested technicians applying known, pre-announced standards.

Q.2. Recent proposals have called for certain reforms of the Federal Reserve System. Do you support individual proposals listed below, and if so, what is the best way to implement such changes? If you do not support an individual proposal listed below, please explain why and provide any feedback you may have on how better to implement the intent of such proposal. Please note that some of the proposal listed below are mutually exclusive and provide your opinion on each proposal individually, and not in the aggregate. If you believe that certain proposals work better in combination with another proposal or proposals, please explain how and why.

Reduce the number of Federal Reserve districts from 12 to 5.

A.2. No. I Oppose. There is rarely clarity about the condition of the economy at or near turning points. The district banks bring information to the FOMC meeting that they gather from business, labor, and other interested parties. Such information is very useful. Fewer Federal Reserve districts would deprive decision makers of accurate regional information.

Q.3. Remove the requirement that the Federal Reserve Bank of New York president have a permanent seat on the FOMC.

A.3. The banking act of 1935 specified that the NY bank was not a permanent member of FOMC. Its vote alternated with Boston. In practice, however, Boston allowed NY to have the vote at every meeting. In 1942 the rules were changed to make NY the permanent member.

The NY bank stays very close to developments in the money and securities markets. The FOMC values that information.

If the Banking Committees adopted and congress legislated a rule, there would be less attention to the money market. A major benefit would be reduced attention to current events and more attention to medium-term changes in the economy. That is what happened when Alan Greenspan more or less followed the Taylor Rule. It gave us the longest period of low inflation, stable growth, and short, mild recessions in Federal Reserve history.

If a rule is adopted, the NY bank would be less “special” and more like other reserve banks.

Q.4. Rotate the Vice Chairmanship of the FOMC position among all Federal Reserve Banks on the FOMC every 2 years.

A.4. I do not think it matters. The vice-chair has no special authority.

Q.5. Make the Presidents of all Federal Reserve Banks voting members on the FOMC.

A.5. I favor that and have proposed it in the past. It gives more weight to developments affecting the general public and less to the financial markets. That was the initial practice. The board of governors did not even participate in the decisions until the 1930s. In the 1920s, the board could only veto decisions about open market operations made by the reserve banks.

Q.6. Remove the trading desk from the Federal Reserve Bank of New York to a lower cost district.

A.6. Not useful. The principal market is in NY and is likely to remain there. The regional bank would be forced to cooperate with NY.

Q.7. Make the New York Fed President a Presidentially nominated and Senate-confirmed position.

A.7. No. That would increase political influence and reduce independence, I prefer steps to make the Federal Reserve (1) more independent and (2) more accountable to the Congress for its actions, good or bad.

Q.8. Require press conferences following each FOMC meeting.

A.8. Useful requirement to provide regular information.

Q.9. Shorten lag time for the release of the FOMC transcripts, and if so, please explain what an appropriate timeframe is.

A.9. The timing of releases has been shortened considerably in the recent past. The current schedule seems fine to me.

Q.10. Codify and clarify the application of FOMC blackout period (i.e., prohibiting Federal Reserve Governors and officials from speaking in public on any matter during the week prior to a FOMC meeting and immediately following an FOMC meeting, which is known as the FOMC blackout period).

A.10. This is a way to prevent leaks and tips to the market or individuals.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER
FROM ALLAN H. MELTZER**

Q.1. Dr. Meltzer, in 2009 at a Banking Committee hearing titled “Establishing a Framework for Systemic Risk Regulation”, [July 23, 2009] former Senator, Chris Dodd, asked you based on your study of the Federal Reserve’s history do you see the bank supervisory role as critical to its monetary policy and function?

You replied, “No sir and the staff has told them many times it is really unrelated. I mean. They can get the information from the other agencies. The reason I believe. The reason the Fed wants supervisory authority is it wants a coalition of people to protect itself against pressures that comes from the Administration and Congress. It wants people that know about the Fed and wants to protect its monetary policy responsibilities and they’ve used it in that way, and in one time in the history the Committee your Committee got very angry at Chairman Burns because of the extent in which he used that mechanism to protect himself against something that the Congress wanted to do.”

Do you think that statement is any less true today, that the Fed wants supervisory authority to protect itself from pressures that come from the Administration and Congress?

A.1. Probably truer because there is more concern and difference of opinion in the Congress and the Administration. The Federal Reserve has acted as an agent of the Administration especially with respect to the debt.

Q.2. If bank supervisory authority is removed from the Federal Reserve, do you think that would negatively impact its ability to conduct monetary policy? If so, how could that be remedied?

A.2. No. Almost surely it would make this claim. In practice it would set up regular meetings to get information from the FDIC and other agencies.

A useful rule of thumb says that agencies like the Federal Reserve should have a single mandate, at times, monetary policy and financial regulation can be in conflict. A single mandate reduces conflict and excuses for making errors.

**RESPONSES TO WRITTEN QUESTIONS OF
CHAIRMAN SHELBY FROM PAUL H. KUPIEC**

Q.1. This past December, both the House and the Senate unanimously passed S. 2270, the Insurance Capital Standards Clarification Act to give the Federal Reserve flexibility to not impose bank-centric capital standards on insurers. The Federal Reserve recently announced that it will undertake a Quantitative Impact Study to determine an appropriate capital regime for insurers. What other studies or additional steps should the Federal Reserve take before issuing capital rules for insurers?

A.1. In the language of the Federal Reserve (Fed) (and the Basel Bank Supervisors Committee), a Quantitative Impact Study (or QIS) means a survey in which a sample of institutions impacted by newly proposed regulation are asked to specifically estimate how the new regulation will affect their business. The survey questions usually take the form of a request for an estimate of how much additional capital (or liquid assets or some other balance sheet factor) will be impacted by the proposed regulation. Such surveys have been done in the past for changes in bank capital regulations proposed by the Basel Committee and subsequently implemented as a regulation in the U.S., often at a more restrictive level than the international Basel agreement specifies and without regard to any QIS assessment of the potential competitive impacts of the stricter U.S. regulation.

In order to undertake a QIS, the Fed must first propose a capital regime for insurers it regulates. Without a capital regime outlined in sufficient detail, there can be no meaningful QIS assessment.

No regulatory capital regime is without shortcomings. Past experience highlights significant flaws in both bank and insurance capital regulations. Still, in any proposed capital regime for insurers, the Fed should be required to clearly document the shortcomings in the existing insurer capital regime and explain how the Fed's proposed capital regime mitigates the weakness in the existing capital rules.

Insurer capital requirements are set to insure that policy holder claims can be paid in full in a timely manner. The timeframe for meeting policy holder claims differs substantially according to the type of insurance sold, and in all cases the payout of insurance claims is much slower process than a sudden "run" withdrawal of bank deposits. The Fed should be required to explicitly state the policy goals associated with its proposed insurance capital regime and explain why the regulatory goal needs to be expanded beyond ensuring that policy holder interests are protected.

Unlike for banks, there is no explicit Federal Government safety net for insurers and no body of empirical evidence that finds that large insurers receive a "safety net funding subsidy." The AIG bailout—multiple Government bailouts actually—were initiated by the Federal Reserve and later joined by the U.S. Treasury. These bailouts provide the sole historical example to support the argument that large FSOC-designated insurers require heighten capital regulation because they enjoy an implicit Government safety net guarantee because of their "too-big-to-fail" status.

Dodd-Frank Act supporters simultaneously argue that because the Act removes the Fed's Section 13 powers for firm-specific bail-

outs and simultaneously creates a new Title II Orderly Liquidation Authority, the Act has ended too-big-to-fail by making government-assisted liquidation a possibility for any large financial firm. If the later claim is true, too-big-to-fail insurers no longer exist and it is unclear why the Federal Reserve needs any supervisory authority over large insurers, or what goals supplemental insurer capital regulation is intended to accomplish.

The Fed should also be required to explain how the proposed changes in the capital regime will reduce the possibility that the failure of a large FSOC-designated insurer will cause wider financial instability. It should be required to provide solid empirical evidence that the benefits of the proposed capital regime changes outweigh costs on consumers.

The Fed should release for public comment its proposed capital regime for insurers and revise the plan based on public, industry, State insurance commissioners, and Congressional reactions before undertaking a QIS study.

Q.2. The Federal Reserve is a key voice at the International Association of Insurance Supervisors (IAIS). The IAIS is currently developing global capital standards for international insurance companies, which would apply to U.S. insurers designated as SIFIs. What specific steps should the Federal Reserve take to ensure U.S. interests are properly represented internationally and that any such international agreements appropriately address the needs of U.S. insurance companies?

A.2. In the U.S., insurance is underwritten and capitalized at the State level according to State regulations, most of which are in conformity with NAIC standards. Insurance company solvency problems, should they occur, are handled at the State level.

From time to time, this State-centric approach to insurance regulation has come under attack by legislators who prefer centralized insurance regulation and the establishment of a Federal insurance regulatory authority. To date, all efforts to establish a centralized insurance regulatory agency have been defeated, including most recently in the Dodd-Frank Act. This State-centric approach to capital, industry conduct and insurance rate regulation has proven to be resilient. It has not been a source of systemic risk for the U.S. financial sector.

The U.S. Congress has never explicitly designated the Federal Reserve as the national insurance regulator or empowered the Fed to negotiate international regulatory capital agreements on behalf of State insurance regulators. The Federal Reserve has unilaterally taken on this authority. Unless the Congress asserts its power to either: (1) specifically empower the Fed to represent the U.S. in these negotiations, imposing appropriate guidelines and restrictions; or, (2) prohibit the Fed from negotiating an international capital agreement on insurance; and, (3) appoint an alternative U.S. representative for these international insurance negotiations with explicit Congressional authorization, guidelines, and restrictions, the Congress will de facto be recognizing the Fed as the national insurance regulator.

Q.3. Estimates suggest the Fed is the consolidated supervisor for a third of the insurance industry's assets vis-a-vis its supervision

of insurance companies that have insurance savings and loan holding companies, as well as companies designated by FSOC. What are the benefits and shortcomings, if any, of having the Federal Reserve supervise and regulate insurance companies compared to State insurance commissioners?

A.3. The issue of Federal regulation of the insurance industry periodically surfaces. Arguments in favor of Federal regulation suggest that State insurance regulation tends to be underfunded, understaffed, and easily captured by the insurance industry. There is probably some truth to these claims, but investigations into consumer complaints about industry conduct, and not issues of insurer financial solvency, tend to be the supervision areas most restricted by State regulatory underfunding.

In contrast, the Federal Reserve is fabulously well-funded and overstaffed. The Fed has proven to be difficult to control, even by the U.S. Congress, and so it is a good bet that it would be difficult for the Fed to be easily “captured” by the insurance industry.

Technically, the Fed has little experience in insurance regulation, but since it pays its employees far better than any U.S. Government or State regulatory agency, with time, it could buy the insurance staff necessary to discharge any insurance supervision function. Fed examinations are also likely to become more standardized over time than the State insurance examinations conducted by the separate State regulators. Given the Federal Reserve pay scale and resource deployed, Federal Reserve examinations are likely to be much more expensive. However, since the Fed does not charge for examinations, the cost will be borne by U.S. taxpayers through high Federal Reserve operating expenses and smaller surpluses returned to the U.S. Treasury.

While there is little doubt in my mind that the Fed would spend far more on the supervision and regulation of the insurance firms within its jurisdiction compared to State insurance regulators, there is little evidence that a significant increase in resources devoted to insurer supervision is justified. The increase in taxpayer expense would not facilitate a measureable improvements in financial system stability, increase the certainty of payment on insurer claims, reduce contingent taxpayer liability for future insurer bailouts, or otherwise improve the prospects for economic growth.

Recent developments suggest that the Fed views insurance regulation as a special subset of bank regulation. Reports suggest that the Fed has decided that the depository institution must always be the recipient of any and all assistance from parent holding companies even when the holding company is dominated by insurance subsidiaries. When insurance subsidiaries appear weakly capitalized by bank regulatory measures, holding companies can thus be required to raise capital so that they can be in a position to support the depository subsidiary if needed, even when the insurance subsidiaries satisfy State regulatory insurance capital requirements. The mixture of insurance and bank capital regulatory approaches is proving problematic as insurance companies end up being subjected to bank minimum capital standards.

If the insurance industry faces two different sets of capital standards—one imposed by State insurance regulation, and the other imposed by the Fed using bank regulatory capital standards as an

overlay on State insurance regulation—then one group of insurers will be at a competitive disadvantage regarding the costs of its policies or the return it offers to its shareholders.

Q.4. The Federal Reserve was granted some oversight authority by Congress over insurance holding companies with depository institution subsidiaries. Because of the added regulatory burden, many relatively small regional insurers with small community banks or thrifts have been divesting their thrifts over the last few years, depriving consumers of the benefits provided by insurers affiliated with banks. What steps has the Federal Reserve taken to ensure that its regulations are properly tailored to fit these unique insurers and do not undermine their business models?

A.4. I am not aware of any adjustments that the Federal Reserve has made in an attempt to tailor its supervision processes or regulations to reduce regulatory burden so that regulation expenses are commensurate with the financial system risks posed by small insurers affiliated with depository institutions.

Q.5. *The Wall Street Journal* recently reported that much of the authority previously delegated to the New York Fed to oversee the many of the Nation's largest banks has been, in effect, revoked and given to a secret committee run by Governor Tarullo. One of Dallas Fed President Fisher's proposals calls for moving supervision of a "systemically important" bank to a district outside where that bank is based in order to address the potential for regulatory capture. Is it better to centralize control of systemic regulation at the Board of Governors of the Federal Reserve System or rotate it among Federal Reserve Banks?

A.5. The Dodd-Frank Act places the responsibility for enhanced supervision of large bank holding companies and FSOC-designated nonbank financial institutions on the Federal Reserve Board.

Unless the Reserve Banks were given explicit new autonomy from the Federal Reserve Board, moving responsibility for enhance supervision of SIFIs to a Reserve Bank would probably not accomplish very much. The Federal Reserve Board would still try to control the process given that it is the part of the Federal Reserve that most accountable to Congress. Moreover, giving unelected Reserve Bank presidents who are not directly accountable to Congress this much new authority seems unwise and inconsistent with our system of Government.

Q.6. Recent proposals have called for certain reforms of the Federal Reserve System. Do you support individual proposals listed below, and if so, what is the best way to implement such changes? If you do not support an individual proposal listed below, please explain why and provide any feedback you may have on how better to implement the intent of such proposal. Please note that some of the proposals listed below are mutually exclusive and provide your opinion on each proposal individually, and not in the aggregate. If you believe that certain proposals work better in combination with another proposal or proposals, please explain how and why.

Reduce the number of Federal Reserve districts from 12 to 5;

A.6. There is no economic or political justification for 12 Federal Reserve districts. Five would suffice.

Q.7. Remove the requirement that the Federal Reserve Bank of New York President have a permanent seat on the FOMC;

A.7. Yes.

Q.8. Rotate the Vice Chairmanship of the FOMC position among all Federal Reserve Banks on the FOMC every 2 years;

A.8. Yes.

Q.9. Make the Presidents of all Federal Reserve Banks voting members on the FOMC;

A.9. Yes, especially if there the number of FR districts are reduced to 5.

Q.10. Remove the trading desk from the Federal Reserve Bank of New York to a lower cost district;

A.10. The trading desk does not need to be in New York given modern communications technology.

Q.11. Make the New York Fed President a Presidentially nominated and Senate-confirmed position;

A.11. No, so long as the special status of NY Fed president are rescinded.

Q.12. Require press conferences following each FOMC meeting;

A.12. No opinion.

Q.13. Shorten lag time for the release of the FOMC transcripts, and if so, please explain what an appropriate timeframe is;

A.13. No opinion.

Q.14. Codify and clarify the application of FOMC blackout period (i.e., prohibiting Federal Reserve Governors and officials from speaking in public on any matter during the week prior to a FOMC meeting and immediately following an FOMC meeting, which is known as the FOMC blackout period).

A.14. No opinion.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM PAUL H. KUPIEC

Q.1. At a Senate Banking Committee hearing in 2009 on “Establishing a Framework for Systemic Risk Regulation”, former Chairman Chris Dodd asked Dr. Meltzer based on his study of the Federal Reserve’s history if he saw the bank supervisory role as critical to its monetary policy and function.

Dr. Meltzer responded, “No sir and the staff has told them many times it is really unrelated. I mean. They can get the information from the other agencies. The reason I believe. The reason the Fed wants supervisory authority is it wants a coalition of people to protect itself against pressures that comes from the Administration and Congress. It wants people that know about the Fed and wants to protect its monetary policy responsibilities and they’ve used it in that way, and in one time in the history the committee your committee got very angry at Chairman Burns because of the extent in which he used that mechanism to protect himself against something that the Congress wanted to do.”

Do you agree or disagree with Dr. Meltzer, and why?

If bank supervisory authority is removed from the Federal Reserve, do you think that would negatively impact its ability to conduct monetary policy? If so, how could that be remedied?

A.1. I agree with Dr. Meltzer. There are no compelling economic reasons why the Federal Reserve needs bank supervisory authority to carry out monetary policy. The Federal Reserve would be able to learn anything it needed to know about the condition of the banking system by merely asking a separate bank supervisory agency.

In the past, the Fed has maintained that it required supervisory powers over bank holding companies in large part so it could have supervisory jurisdiction over large national banks. There is really no need for multiple bank regulators, and Fed's post Dodd-Frank regulatory activities are a major threat to its "independence." The Congress must clearly exercise more intrusive oversight over an institution that now routinely makes operating decisions for the largest banks. Decisions that used to be routinely made by banks' directors must garner Fed approval on all banking institutions larger than \$50 billion.

Increasingly, the Fed is supporting its sustained 0-interest rate policy by using its new Dodd-Frank enhanced supervisory powers. The Fed is worried that 0 rates have sparked financial bubbles and so the Fed now tells banks which type of investments are "sound" and which are "too risky." The Fed calls this "macroprudential policy," but it comes very close to central planning.

Using the justification of macroprudential policy, the Fed is essentially arguing that it can keep the monetary accelerator to the floor if only it is allowed to control the investments banks make. Moreover, senior Fed officials are publically claiming that they need to extend this control to "shadow banks" which is really code for the rest of the financial sector. In fact, the Fed has already agreed to this strategy which is being planned by the Financial Stability Board. The Fed is now exerting pressure to discourage certain types of lending—in essence, approving which investments banks should make and which they must avoid, and it wants to extend this power to nonbank financial institutions.

This macroprudential policy experiment can only end badly, since history has demonstrated time and again, that the Fed's crystal ball has a bad case of myopia. Fed control over bank and other financial firm investments will either produce prolonged sluggish growth as banks and "shadow banks" are required to avoid sound high return investments because the Fed sees them as too risky, or it will end with large financial sector losses because the Fed will fail to identify and stop a financial bubble before the economic damage is done. The probability the Fed will have the foresight and judgement to engineer a "goldilocks path" is about 0.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HELLER FROM PAUL H. KUPIEC

Q.1. The Federal Reserve is increasingly more involved in international negotiations on financial regulations. In the United States we have a very unique banking and insurance structure compared to Europe. Yet, more and more we are hearing about the Financial

Stability Board and the International Association of Insurance Supervisors. A prevalence of groupthink is starting to develop among the world's financial regulators with the Federal Reserve often being a participant in these negotiations.

How can we have greater oversight over international negotiations and should there be more public disclosures and reports before and after Federal Reserve officials engage in international negotiations?

A.1. Groupthink is an especially important problem that has been created by international regulatory agreements. For example, the Basel Market Risk Amendment and Basel II credit risk requirements substantially lowered bank capital requirements intentionally, as a reward, to get banks to adopt a new system of economic model-based capital requirements. International regulators—including (and indeed especially) the Federal Reserve—were very clear when they were finalizing the Basel II. Their claim was that the safety and soundness of large banks would be improved by allowing banks to use internal model based capital requirements to replace the prior Basel Accord regime of fixed risk weights. International regulators claimed that, because these new model-based capital requirements better aligned bank risk with minimum capital requirements, the large banks that adopted the new capital scheme could operate with lower capital levels because the appropriate capital was calculated more accurately.

All the international bank regulators bought into the talking point that lower bank capital was appropriate given the new risk-sensitive capital rules. And shortly after Basel II was finalized in 2006, the folly of this regulatory groupthink was revealed as many large internationally active banks that adopted the Basel II model-based capital requirements required capital injections from their Governments. The regulators' talking points after the crisis claimed that the Basel II capital requirement approach really was solution to the problems of the crisis—and not the cause—and what the world needed was of this type of regulation to ensure a crisis never happened again.

The real truth behind the crisis was that Basel II and the Market Risk Amendments were riddled with errors and mistakes that allowed banks to hold very little capital for extremely risky positions. Regulators never owned up to their mistakes, but instead modified the rules to produce a newer even more complex Basel III capital agreement, and in the process fixed the mistakes that the crisis revealed in the earlier Basel II and Market Risk Amendment rules without ever admitting as much in public.

The capacity for regulators to agree to flawed international regulatory and supervisory policies and succumb to groupthink errors has not diminished since the crisis. For example, the new Basel III international agreement requires large banks to meet a so-called Liquidity Coverage Ratio (or LCR). The LCR has had the unintended consequence of making it unprofitable for banks to accept large deposits from nonbank financial institutions while interest rates are near zero (actually negative in some countries). Indeed many banks in Europe, and now increasingly banks in the U.S. are charging very large negative interest rates on financial institution deposits to encourage these deposits to leave the bank. What is the

point of a banking system if it cannot afford to accept deposits? And yet this is the situation today, and it is the new international bank regulations that are forcing liquidity out of the banking system into nonbank financial institutions.

Already the Federal Reserve is arguing publically that they need extended regulatory jurisdiction over “shadow banks” so they can try to chase the liquidity leaving the banking system and regulate it elsewhere.

Financial regulations have become increasingly complex. Consequently these regulations are difficult to assess and monitor. This complexity hinders Congressional oversight and works to further empower the Federal Reserve. However difficult, without strong Congressional oversight, the Fed becomes an unaccountable while it is increasingly acting like central planner as it develops new regulations that allocate credit and investment in the economy.

Financial regulations have important impacts on the savings and investment decisions of millions of Americans consumers and business with ramifications that ultimately negatively impact the growth rate of the American economy. I unaware of any historical instance when the introduction of new complex and extensive financial regulations caused an increase in economic growth.

Effective oversight will require the Congress to be vigilant in asking for information and holding regular hearings on the Fed’s international regulatory activities. Following the idea of a Bill introduced in the House last summer, the Congress might require the Fed to make prior notification to Congress before attending international meetings and include a briefing on the materials and issues to be covered. The Bill would also require the Fed to provide Congressional Committees with a summary of agreements and discussions following the international meeting.

Additionally, Congress might consider passing legislation to limit the Fed’s involvement in these negotiations by, for example, restricting the Fed’s authority to banking issues and prohibit it from representing the U.S. in international insurance regulatory negotiations.

The current situation leaves the Fed with tremendous power over international financial regulatory developments—powers that should reside in the U.S. Congress. Such a concentration of power in an independent agency that is only weakly accountable to Congress is not a recipe for good Government. The Congress should empower a different agent to represent the U.S. in international insurance regulatory negotiations and step up monitoring of the Fed’s international participation in other Financial Stability Board and Basel Banking Supervision Committee negotiations.

Q.2. The Federal Reserve is a member of the International Association of Insurance Supervisors (IAIS) and is actively participating in the creation of insurance capital standards for internationally active insurance companies.

Do you believe the Federal Reserve should advocate for the U.S. State insurance system, which performed well in the financial crisis, to be recognized by other jurisdictions as one way to comply with the IAIS insurance capital standard or do you believe that State insurance solvency standards should be preempted by Federal application of some version of the IAIS standards?

A.2. Unless the Congress wishes to empower the Federal Reserve as the de facto U.S. national insurance regulator, the Congress should explicitly empower an agent other than the Federal Reserve as the recognized U.S. representative in IAIS capital negotiations. If Congress does nothing, the Fed will fill the role of national insurance regulator.

If Congress decides to empower the Fed as the recognized U.S. IAIS representative, then it should move quickly to put restrictions on this power and create a system for oversight and monitoring the Fed's exercise of this power.

My own opinion is that this insurance regulation power should not be concentrated in the Federal Reserve.

Q.3. Shortly after the Federal Reserve joined the International Association of Insurance Supervisors (IAIS), the IAIS voted behind closed doors to shut out public observers, including consumer groups, from most of their meetings.

Do you believe that the Federal Reserve should be committed to being transparent in its operations, and support allowing the public to observe the IAIS meetings in the same way Congress—and this Committee—does with its hearings and markups?

A.3. Transparency is important and could be achieved by either opening up the IAIS meetings themselves, or by requiring the Federal Reserve or other congressionally appointed U.S. representative to the IAIS, to provide a full and timely accounting of each meeting, including a summary of all discussions and agreements, to the appropriate Congressional subcommittee and on a publically accessible Web site.

RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN SHELBY FROM PETER CONTI-BROWN

Q.1. Recent proposals have called for certain reforms of the Federal Reserve System. Do you support individual proposals listed below, and if so, what is the best way to implement such changes? If you do not support an individual proposal listed below, please explain why and provide any feedback you may have on how better to implement the intent of such proposal. Please note that some of the proposal listed below are mutually exclusive and provide your opinion on each proposal individually, and not in the aggregate. If you believe that certain proposals work better in combination with another proposal or proposals, please explain how and why.

Reduce the number of Federal Reserve districts from 12 to 5.

A.1. I'm not exactly sure what this proposal would accomplish. I support making the governance of the Federal Reserve System—especially at the Federal Reserve Banks—more transparent to the public. By “governance,” I mean the selection of the directors and officers of the Reserve Banks. By “transparent,” I mean making the process by which the directors and officers are selected subject to greater public participation. I favor making the directors of the Reserve Banks purely advisory, and the presidents of the Reserve Banks appointed and removable by the Fed's Board of Governors.

Reducing the number of Federal Reserve districts eliminates some of the influence of the Reserve Banks, but simply con-

centrates that influence in the other five districts. The governance problems in the remaining five districts would remain unchanged.

Q.2. Remove the requirement that the Federal Reserve Bank of New York President have a permanent seat on the FOMC.

A.2. I favor this proposal. Doing so would require a change to 12 U.S.C. §263(a) and would add the New York Fed into one of the rotations followed by the other Reserve Banks.

Q.3. Rotate the Vice Chairmanship of the FOMC position among all Federal Reserve Banks on the FOMC every 2 years.

A.3. In our digital age, when the physical transfer of cash, gold, and securities plays a much smaller role in the supervision of the financial and payment system, the justification for the New York Fed's Vice Chairmanship no longer exists. In the previous era, given the concentration of financial services in the second district (where the New York Fed sits), this prominence made more sense.

But I'm not sure rotating the Vice Chairmanship among Reserve Banks actually makes sense, for much the same reason. The Reserve Banks themselves don't serve the vital physical delivery process that they once served in the operation of our financial system. All respect to these great cities, but it's unclear to me why Richmond or Cleveland or Kansas City should have enhanced representation in the formulation of our monetary policy.

A better solution would be toward simplifying, rather than complicating, the governance structure of the Fed by making the Vice Chair of the FOMC and the Vice Chair of the Board of Governors one in the same. The current Vice Chair of the Board of Governors is an eminent economist and central banker, Stanley Fischer. But his most important qualification is this: the U.S. President nominated him, and the U.S. Senate confirmed him. The public had a chance to participate in his vetting and confirmation process. The same cannot be said for any of the Reserve Bank presidents.

Q.4. Make the Presidents of all Federal Reserve Banks voting members on the FOMC.

A.4. I oppose this proposal. Given the problematic governance structure of the Reserve Banks, their enhanced participation on the FOMC would only dilute appropriate congressional control over the staffing of our monetary policy. While I do not support efforts to impose more congressional control on the day-to-day of monetary policy, I do support efforts to impose more congressional control on who gets to wield this authority in the first place. Extending the Reserve Banks' participation on the FOMC is a move in the wrong direction.

Q.5. Remove the trading desk from the Federal Reserve Bank of New York to a lower cost district.

A.5. This is a very practical proposal. Again, the costs of market interventions are not what they were in the era when the FRBNY was given its pride of place.

That said, there will be transition costs in moving the trading desk, in terms of institutional knowledge lost in the transfer (I assume not all FRBNY personnel would be willing to relocate). Even so, these costs would not be permanent. Before endorsing this proposal definitively, I would want to quantify the costs associated

with this transition and measure them against the savings of the relocation. I imagine the costs would be relatively minor in comparison to the savings.

Q.6. Make the New York Fed President a Presidentially nominated and Senate-confirmed position.

A.6. This proposal focuses on exactly the right issue: making the Reserve Bank presidents more accountable to the democratic process, without erasing the benefits of a central bank insulated from the political process. The current selection, appointment, and removal procedures for the Reserve Bank presidents raise policy and even constitutional concerns that the Congress should address.

Even so, I don't support this proposal, for two reasons. First, it does nothing to the other 11 Reserve Banks. Their governance problems are just as significant, even if the New York Fed's district is home to some of the Nation's largest financial institutions. Leaving the Reserve Banks' governance untouched beyond New York would be problematic.

Second, and ironically, giving the New York Fed a presidential appointment may make the New York Fed more independent of the rest of the System, and potentially more dependent on the financial industry in New York. If the New York Fed president is a presidential appointment, she will become the focus of extraordinary lobbying efforts. If the industry succeeds in placing a friendly regulator in its backyard, efforts from elsewhere in the System—principally from the Board of Governors—to be a more critical regulator could be thwarted. A presidential appointment might give the FRBNY an independent power base that could lead to great confusion within the System.

In its place, I recommend placing all Reserve Bank appointments (and their removal) in the hands of the Board of Governors.

Q.7. Require press conferences following each FOMC meeting.

A.7. I like this proposal very much. We learned a lot from the March 18, 2015, press conference. It provides a mechanism for the Fed Chair to communicate through the press in a way that is less scripted than press releases and less overtly political than congressional hearings. The Fed has been moving toward press conferences in the last decade; I would like to see this become a matter of practice.

Q.8. Shorten lag time for the release of the FOMC transcripts, and if so, please explain what an appropriate timeframe is.

A.8. I favor the 5-year lag. It gives enough time to insulate, at least to some extent, the day-to-day monetary policy the Fed from becoming too intensely connected to a quadrennial election cycle.

Q.9. Codify and clarify the application of FOMC blackout period (i.e., prohibiting Federal Reserve Governors and officials from speaking in public on any matter during the week prior to a FOMC meeting and immediately following an FOMC meeting, which is known as the FOMC blackout period).

A.9. The blackout period is, at present, clearly stated: "The blackout period will begin at midnight Eastern Time seven days before the beginning of the meeting . . . and will end at midnight Eastern Time on the next day after the meeting." With many others, I anx-

iously await the Fed's Inspector General report on FOMC leaks to understand better how that leak occurred and what measures, if any, should be taken to prevent them in the future.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER
FROM PETER CONTI-BROWN**

Q.1. At a Senate Banking Committee hearing in 2009 on "Establishing a Framework for Systemic Risk Regulation", former Chairman Chris Dodd asked Dr. Meltzer based on his study of the Federal Reserve's history if he saw the bank supervisory role as critical to its monetary policy and function.

Dr. Meltzer responded, "No sir and the staff has told them many times it is really unrelated. I mean. They can get the information from the other agencies. The reason I believe. The reason the Fed wants supervisory authority is it wants a coalition of people to protect itself against pressures that comes from the Administration and Congress. It wants people that know about the Fed and wants to protect its monetary policy responsibilities and they've used it in that way, and in one time in the history the Committee your Committee got very angry at Chairman Burns because of the extent in which he used that mechanism to protect himself against something that the Congress wanted to do."

Do you agree or disagree with Dr. Meltzer, and why?

A.1. I agree with Dr. Meltzer that, historically, much of the banking supervisory apparatus has come to the Fed in ways completely disconnected from its role in monetary policy. As I document in my forthcoming book, the Fed was agnostic regarding its selection as the regulator for Bank Holding Companies in 1956, and hostile to the role it was given in regulating the Truth in Lending Act (now the purview of the Consumer Financial Protection Bureau). These functions were not seen by the Fed—rightly, I think—as essential to its monetary missions.

And several Administrations, from both parties, have sought to consolidate banking regulation in the hands of a single, non-Fed regulator. For example, Presidents Lyndon Johnson, Bill Clinton, and George W. Bush all proposed this kind of supervisory consolidation of functions that are currently spread across the executive and independent agencies.

I am less certain than Dr. Meltzer that the Fed can appropriately formulate and implement traditional central banking functions without retaining regulatory and supervisory authority over systemically important financial institutions. The problem is in the appropriate deployment of emergency lending authority, sometimes broadly called the "lender of last resort function." There is a central tension in the use of the central bank (or Government, or any other authority) as a lender of last resort. On the one hand, the central bank must be available when all other lending avenues have failed to secure and support the financial system. On the other, if banks know that the central bank will provide whatever liquidity is necessary to save them in the event of crisis, the banks will not take appropriate measures to avoid the crisis in the first place. This is the "moral hazard" problem that was so central to discussions of the recent financial crisis and the Fed's response to it.

If the Fed retains its emergency lending authority, but loses the regulatory authority over those who would use that emergency lending authority, the risk of moral hazard is extraordinary. It is not simply an information-sharing problem, as Dr. Meltzer described. The Fed must be in a position to regulate and supervise financial institutions with an eye toward preventing financial crises before they start, followed by appropriately stringent regulatory controls over the use of emergency lending funds in the event of crisis, and postcrisis repayment in ways that do not exacerbate moral hazard. For these reasons, I fear that stripping the Fed of all its regulatory authority would make financial crises more likely, not less likely.

That said, this conception of the Fed's regulatory authority applies to its supervision of the largest financial institutions. It does not apply to others. I am in favor of a consolidation of financial regulatory authority for other institutions into a single agency, similar to the Clinton and George W. Bush proposals.

Q.2. If bank supervisory authority is removed from the Federal Reserve, do you think that would negatively impact its ability to conduct monetary policy? If so, how could that be remedied?

A.2. See above for the discussion of emergency lending.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

CHART OF THE FEDERAL RESERVE SURVEY OF CONSUMER FINANCES, SUBMITTED BY SENATOR BROWN

Federal Reserve Survey of Consumer Finances

AVERAGE FAMILY WEALTH BY RACE AND ETHNICITY, 1983–2010

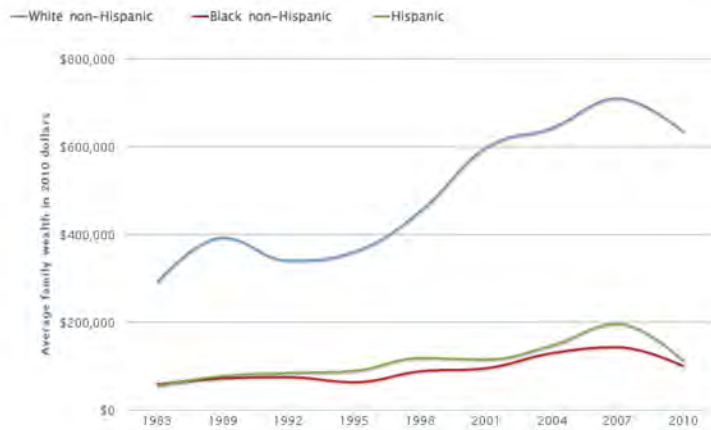


Figure from "Less Than Equal: Racial Disparities in Wealth Accumulation," The Urban Institute, April 2013.
 Source: Author's tabulations of the 1983, 1989, 1992, 1995, 1998, 2001, 2004, 2010 Survey of Consumer Finances (SCF).
 Notes: All values are presented in 2010 dollars, and data are weighted using SCF weights.

TESTIMONY OF RON PAUL, CHAIRMAN, CAMPAIGN FOR LIBERTY

Testimony of Campaign for Liberty Chairman Ron Paul

Senate Banking, Housing, and Urban Affairs Committee Hearing on Federal Reserve Reform

March 3, 2015

Chairman Shelby, Ranking Member Brown, and members of the Senate Banking, Housing, and Urban Affairs Committee, thank you for holding this hearing on the important topic of Federal Reserve Reform. On behalf of Campaign for Liberty's nearly three quarters of a million members, I request the Senate Banking Committee follow up this hearing by taking the first step toward Federal Reserve reform by reporting S. 264, the Federal Reserve Transparency Act, better known as Audit the Fed, out of committee and to the floor for consideration as soon as possible.

The Audit the Fed bill introduced in the Senate by Senator Rand Paul has the bipartisan support of 32 cosponsors. Its House companion, H.R. 24, has been introduced by Representative Thomas Massie and continues to build support, currently featuring 141 cosponsors. This vital legislation has twice passed the House of Representatives. In 2012, it passed by a vote of 327 to 98. In 2014, it passed by a vote of 333 to 92. Despite passing the House twice with overwhelming majorities, it has never received a standalone, roll call vote in the Senate.

The Audit the Fed legislation repeals language in Subsection (b) of Title 31 Section 714 of federal law prohibiting a full audit of the Federal Reserve's monetary policy operations. The bill requires the Government Accountability Office (GAO) to perform an audit of the Fed's discount window operations, open market operations, agreements with foreign governments and central banks, and Federal Open Market Committee directives within a year after the bill becomes law.

A full audit will also allow Congress to finally carry out informed oversight of this congressionally created institution by revealing what deals the Federal Reserve has made with foreign central banks and governments, Wall Street firms, and American banks. It will help Congress and the people better understand how the Fed evaluates economic conditions and what contingency plans it is drawing up in the event of a recession, or a market meltdown similar to what occurred in 2008.

In recent weeks, the Federal Reserve, along with its apologists in Congress, the financial sector, and the establishment media, has been waging an unprecedented public relations campaign against this bill. Of course, the Federal Reserve does not want to admit they oppose transparency, so they are resorting to distorting the intent and effect of this bill.

The most common criticism of the Audit the Fed bill is that it will somehow limit the Federal Reserve's independence. There are two flaws with this argument.

First, nothing in the Audit the Fed bill gives Congress any new powers to interfere with the Federal Reserve's conduct of monetary policy. Despite repeated requests, neither Federal Reserve Chair Yellen nor any other opponent of the audit bill can point to any section of the bill that gives Congress any new authority over the Federal Reserve's operations. The reason they cannot point to such a section is simple; there is nothing in the text of this bill giving Congress any such new authority.

Secondly, the idea the Federal Reserve is "independent" of political pressure is a myth. It is so common for the Fed to adjust its policies to help or hurt incumbent politicians that economists have a name for it:

the “political business cycle.” As economists Daniel Smith and Peter Boettke put it in their paper “An Episodic History of Modern Fed Independence,” the Federal Reserve “regularly accommodates debt, succumbs to political pressures, and follows bureaucratic tendencies, compromising the Fed’s operational independence.”¹

Writing in *Forbes*, Dr. Norbert Michel of the Heritage Foundation summarized Smith and Boettke’s history of Federal Reserve chairmen adapting policies to please the current administration:

- William Martin (1951 – 1970). President Eisenhower directed his Treasury Secretary to put the “utmost pressure” on Chairman Martin to “get a greater money supply throughout the country.” When Martin refused, Eisenhower pressured him to resign or reconsider. Martin reconsidered.
- Arthur Burns (1970 – 1978). President Nixon repeatedly worked with Burns to secure easy monetary policy with the view that it would help win elections. On one of Nixon’s famous tapes, Nixon and Burns openly mocked the idea of Federal Reserve independence.
- G. William Miller (1978 – 1979). President Carter found Miller uncooperative, so he replaced him as Fed Chair (he made Miller his Treasury Secretary).
- Paul Volcker (1979 – 1984). Ronald Reagan openly cultivated a working relationship with Volcker and repeatedly asked him for tighter monetary policy. Alan Greenspan reports that, in one meeting, Reagan reminded Volcker that the Federal Reserve Act was subject to change.
- Alan Greenspan (1987 – 2006). Alan Blinder, appointed to the Fed Board by President Clinton, publicly suggested Greenspan was catering to Clinton.
- Ben Bernanke (2006 – 2014). [A 2012 New York Fed publication notes](#): “The U.S. Treasury and the Federal Reserve System have long enjoyed a close relationship.... This relationship proved beneficial during the 2008-09 financial crisis, when the Treasury altered its cash management practices to facilitate the Fed’s dramatic expansion of credit to banks, primary dealers, and foreign central banks.”²

Chair Yellen claims that had the audit bill been in effect in the late seventies and early eighties, then-Federal Reserve Chairman Paul Volcker would have faced irreversible pressure from Congress to abandon his efforts to keep interest rates high. This statement is ironic considering that the one reason America faced hyperinflation in the seventies was because several of Mr. Volker’s predecessors accommodated the Executive Branch’s desire for cheap money.

Opponents of the audit bill also claim that the Federal Reserve is already audited and is fully transparent. These arguments are at best disingenuous, at worst, outright deceitful. While it is true the Federal Reserve is subject to some limited audits, these are financial audits that only reveal the amount of assets on the Fed’s balance sheets. The Audit the Fed bill will reveal what was purchased, when they were acquired, and why they were acquired.

¹ Smith, Daniel J. and Boettke, Peter J., “An Episodic History of Modern Fed Independence.” 11 December 2014. Available at SSRN: <http://ssrn.com/abstract=2135233> or <http://dx.doi.org/10.2139/ssrn.2135233>

² Michel, Norbert. “The Fed Is Nervous, And Maybe That’s A Good Thing.” *Forbes.com*. 09 February 2015, with citations from Smith and Boettke’s “An Episodic History of Modern Fed Independence.”

Perhaps the real reason why the Federal Reserve fears a full audit is revealed by examining the results of the one-time GAO audit of the Federal Reserve's response to the financial crisis that was authorized by the Dodd-Frank Act. This audit revealed that between 2007 and 2010, the Federal Reserve committed over \$16 trillion — more than four times the annual budget of the United States — to foreign central banks and politically influential private companies.

More evidence of what the audit might reveal was raised in 2013 when former Federal Reserve official Andrew Huszar publicly apologized to the American people for his role in what he called “the greatest backdoor Wall Street bailout of all time” — the Federal Reserve's Quantitative Easing program.³ Can anyone doubt an audit would further confirm how the Fed acts to benefit the economic elites?

Ironically, the Federal Reserve and its allies being forced to resort to distortions and fear-mongering about the bill shows there is no legitimate reason Congress should not pass this bill immediately.

Every American is affected by the manner in which the Federal Reserve performs its core function: the conduct of monetary policy. Yet federal law prohibits the people, through their elected representatives, from learning the full truth about how the Federal Reserve conducts monetary policy. It is long past time to bring transparency to monetary policy.

Therefore, on behalf of Campaign for Liberty's nearly three quarters of a million members, and the nearly 75% of American people that support auditing the Fed, I urge this Committee to report Audit the Fed out as soon as possible so the Senate can finally hold an up or down vote on this important legislation.

³ Huszar, Andrew. “Andrew Huszar: Confessions of a Quantitative Easer.” *WSJ.com: The Wall Street Journal*. 11 November 2013.